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## Understanding PCI Compliance and Cloud Computing pg 24



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# Eliminate the Value Impasse in Buy-Sell Agreements

**BY ZACH SHARKEY, CFA, CPA/ABV**

Defining 'value' in buy-sell agreements of closely-held businesses is frequently a dubious practice for attorneys and business appraisers alike. Articulating the standard of value (e.g., fair market value, fair value) receives disproportionate attention to the peril of somewhat obscure valuation concerns, notably the level of value. Despite the attention the standard of value receives, the concluded value definition is frequently illogical. Whether erroneously defined, ambiguous, or absent altogether, correctly defining the client's intent of value remains unnecessarily problematic.

The cardinal objective of this article is to examine the levels of value in buy-sell agreements and the importance of accurately defining the level of value intended by the client. The following paragraph is relatively standard language taken from an actual buy-sell agreement (emphasis added):

> "Fair Market Value" means the amount agreed to in writing between Company and the selling Shareholder within thirty (30) days after the date of the Triggering Event. In the event no agreement is reached within such period, "Fair Market Value" means the amount a willing buyer would pay a willing seller for the Shares being purchased under all the circumstances, using commercially reasonable valuation standards, *without taking into account premiums for control or change of control (what a strategic buyer would pay) and without applying discounts for minority interests and lack of marketability.* The determination of Fair Market Value shall be determined by an appraiser selected by the Company.

Let's take a closer look at the italicized clause above. No adjustment for the price should be applied, whether the adjustment is a premium or discount (of any kind). Here's where the fault lies: *an implied discount or premium is embedded in the value by default, depending on the valuation approach used.* Therefore, the buy-sell agreement's desired level of value must be precise for the appraiser to select the proper approaches and methods when performing the business valuation.

Take an example where the interest at hand is a 10 percent (minority) interest of a going-concern, closely-held operating company. Typical normalization adjustments have been made. Abiding to the agreement, no cash flow or multiple adjustments have been made to elevate the level of value from minority to control.

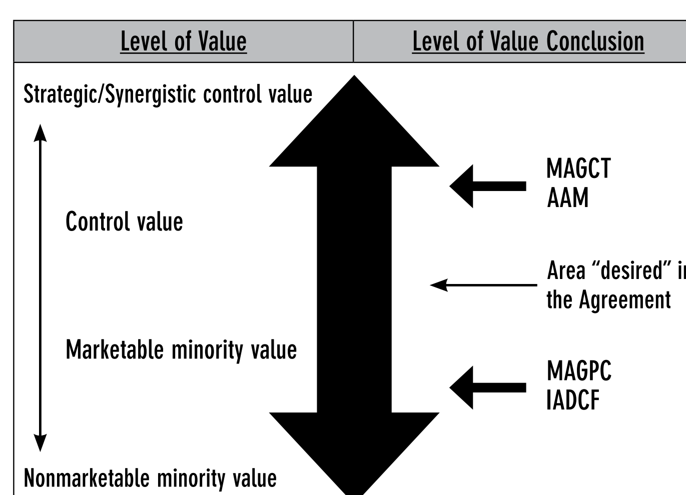
Considering three common approaches to business valuation (Market, Income and Asset approaches)—and some of their respective methods (noted in Exhibit I)—provides the following levels of value conclusions. Adhering to the buy-sell agreement, these value conclusions are reached without applying discounts or premiums.

### Exhibit I

| Approach | Method | Level |
|---|---|---|
| 1. Market Approach | Guideline public company method (MAGPC) | minority |
| | Guideline company transaction method (MAGCT) | control |
| 2. Income Approach | Discounted cash flow method (IADCF) | minority |
| 3. Asset Approach | Adjusted asset method (AAM) | control |

Exhibit II is a graphical rendition of the value hierarchy. The left side delineates the levels of value (range) whereas the right side represents the level of value conclusions under the approaches and methods from Exhibit I.

### Exhibit II



The level of value using the discounted cash flow or guideline public company methods is that of a minority shareholder. No controlling adjustments are permitted per the buy-sell agreement. The cost of capital used to discount the cash flow streams under the discounted cash flow method is based upon publicly traded, minority interest shares, as are the multiples used for the guideline public company method. This level of value is lower than the level of value desired in this example.

In contrast, the level of value using the guideline company transaction or adjusted asset methods is that of a controlling shareholder. The guideline company transaction method uses multiples from observed control transactions, providing a control level of value. The adjusted asset method substitutes the company's assets' book values to current prices and nets out existing debt. The residual—or adjusted asset value—is a control level of value. Only a controlling interest level would have the ability to liquidate and realize the residual. This level of value is higher than the level of value desired in this example. Other methods could also be justified and still provide divergent levels of value.

The Fair Market Value standard defined in Revenue Ruling 59-60 states that "A sound valuation will be based upon all the relevant facts, but the *elements of common sense, informed judgment and reasonableness* must enter into the process of weighing those facts and weighing their significance" (emphasis added). This sentence encapsulates the heart of business valuation. It is both an art and a science, with subjectivity and latitude expected to be used by the business appraiser in harmony with the ruling's guidelines. The following situation exemplifies the subjectivity appraisers will use without specific guidance.

Continuing with the previous example of a 10 percent interest and the buy-sell agreement language, assume that two appraisers are hired to value the company. The standard of value is Fair Market Value, as defined in the buy-sell agreement, and no discounts or control premiums are to be applied. Appraiser A uses the income approach and the discounted cash flow method. Appraiser B uses the market approach and the guideline company transaction method. The former method uses discount rates obtained from minority interest publicly traded equities (resulting in a minority level of value conclusion), whereas the latter method uses acquisition multiples from transactions that have occurred in the company's industry (yielding a control level of value conclusion.) An implied discount is included in the former compared to an implied premium in the latter. Exhibit III illustrates the alarming valuation differential that can occur because the level of value was not specified in the buy-sell agreement.

## Exhibit III

| | Appraiser A | Appraiser B |
|---|---|---|
| Approach: | Income Approach | Market Approach |
| Method: | Discounted cash flow method | Guideline company transaction method |
| Estimated Value: | $5,000,000 | $5,750,000 |

In accordance to the buy-sell agreement, the appraisers were instructed to abide by the following:

- *"'Fair Market Value' means the amount a willing buyer would pay a willing seller for the Shares being purchased under all the circumstances…"*

  Ambiguous wording begets subjective interpretation to what "all the circumstances" truly means. The 10 percent interest would usually be considered a minority interest. However, assume one of the shareholders owned 41 percent of the company. Purchasing the 10 percent interest would convert the purchasing shareholder from a minority shareholder to a controlling shareholder. If the appraiser believes the 41 percent shareholder may purchase the 10 percent interest, how does she determine the level of value for the 10 percent interest? As noted in Exhibit III, control value is a bona fide premium shareholders pay for.

- *"…without taking into account premiums for control or change of control (what a strategic buyer would pay) and without applying discounts for minority interests and lack of marketability."*

  No control premiums or discounts should be applied. Not applying premiums or discounts is perfectly acceptable if the level of value is provided. Because different approaches and methods implicitly result in diverging levels of value without applying premiums or discounts, this guidance is flawed. The appraisers were left to choose the level of value.

Consequently, an implied 15 percent premium is embedded in the value conclusion of Appraiser B relative to Appraiser A's value conclusion. The company's industry ascribes a 15 percent premium for a controlling level of value compared to a minority level. The document's language failed the client by not directing the appraisers to a specific level of value, and thus, the appropriate method to use. Appraiser A believed the income stream projections were sufficient to perform a discounted cash flow value method. Appraiser B preferred quantifiable observable transactions and opted to use the guideline company transaction method. After reviewing the financial information and buy-sell agreement, and discussing why each appraiser selected her respective approach, the conclusion was: they were both correct.

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To determine which method was more reasonable in this case, the next step was to review control premiums and transaction premiums for the industry. Accepting the median transaction premium multiple as reasonable, the premium (17 percent) could then be converted into a discount for lack of control (DLOC). This process is shown in Exhibit IV.

### Exhibit IV

| DLOC = 1 – 1 / (1 + Premium) | |
|---|---|
| Median premium | 17% |
| Implied DLOC | 15% |

The observable median industry premium of 17 percent implies a 15 percent discount for lack of control. Remember, the discounted cash flow method used by Appraiser A produced a minority interest level of value. To check the reasonableness of Appraiser B's value estimate (a control value), a discount for lack of control must be applied to determine the minority level of value.

### Exhibit V

| | Appraiser A | Appraiser B |
|---|---|---|
| Approach: | Income Approach | Market Approach |
| Method: | Discounted cash flow method | Guideline company transaction method |
| Estimated Value: | $5,000,000 | $5,750,000 |
| DLOC of 15% to control value: | | $835,470 |
| Minority level of value: | $5,000,000 | $4,914,530 |

A mere 2 percent variance exists between the value conclusions when calculated on the same level of value. The document's ambiguity in determining what Fair Market Value meant left a sinister amount of subjectivity, and neither of the appraiser's methods—and the reasons they selected them—were found unreasonable.

## Moving Forward

Including language in the buy-sell agreement that prescribes the specific approaches and methods to be used is one way of alleviating the level of value problem. However, this can be highly problematic. For example, the income approach relies on a firm's ability to project cash flow streams into the future with a high degree of certainty. If income is erratic or a firm is unable to project cash flows with a fundamental degree of certainty, the income approach may not be deemed appropriate by the appraiser. Likewise, the market approach relies on finding either comparable publicly traded guideline companies (the guideline public company method) or transactions that "make sense" within the company's industry (the guideline company transaction method). Not every approach is appropriate, given the nature and circumstances of the company being appraised. For these reasons, the approaches and methods used should be left to the appraiser's professional judgment.

The best way to solve the level of value problem may be to define it, then let the appraiser do her job in deciding which approaches and methods are most suitable. Use a graph defining the levels of value (as shown in Exhibit II) and include that in your agreement for further clarity. Defining the level of value in text and visually depicting your intent leaves no room for interpretation.

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