Thought Leadership

Do M&A Transaction Prices Reflect Fair Market Value for Ad Valorem Property Tax Purposes?

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One market approach valuation method that is sometimes used in a unit principle valuation analysis is the guideline merged and acquired company method. The guideline merged and acquired company method values the taxpayer property by applying valuation pricing multiples extracted from actual purchases of guideline (or comparative) operating businesses. The analytical issue associated with the use of the guideline merged and acquired company method is that it may overstate the fair market value of the subject property. This value overstatement may occur because the prices paid in merger and acquisition (M&A) transactions are often greater than fair market value prices. This discussion explains some of the reasons why corporate acquirers sometimes pay more than fair market value prices in M&A transactions. And, this discussion explores empirical data to support the conclusion that market-based transaction prices often represent a value other than (and greater than) fair market value.

Introduction

Both taxing authorities and taxpayers often use the market approach to estimate unit values for ad valorem property tax purposes. The unit principle valuation (versus the summation principle valuation) is often applied in the appraisal of centrally assessed industrial and commercial taxpayer properties.

Such centrally assessed taxpayer properties (such as railroads, pipelines, airlines, electric utilities) often cross taxing jurisdiction boundaries. The unit principle valuation is also applied to the property taxation of some locally assessed properties when the properties are physically or functionally integrated. Examples of such locally assessed taxpayer properties may include cable TV systems, water and wastewater systems, and complex oil/natural gas refineries.

One market approach valuation method that is sometimes used in a unit principle property valuation is the guideline merged and acquired company method. In this method, valuation pricing multiples are extracted from the prices of merged/acquired going-concern business entities. These market-derived pricing multiples are then applied to the financial fundamentals of the subject property in order to estimate the fair market value of the subject taxable assets.

This discussion addresses

1. the reasons why an acquisitive transaction may occur at a price other than (and greater than) a fair market value price and
2. the issue that merger and acquisition (M&A) transaction pricing data used to estimate the unit of taxable operating assets may not represent fair market value.

These issues are particularly relevant to centrally assessed taxpayers with regard to the unit principle property tax assessment, negotiation, appeal, and litigation.

Fair Market Value versus Investment Value

Fair market value (or some variation of the standard of fair market value) is usually the appropriate standard (or definition) of value in most taxing jurisdictions for ad valorem property tax purposes. The standard of fair market value is defined in the American Institute of Certified Public Accountants (AICPA) Statement on Standards for Valuation Services 1 (SSVS 1) as:

> The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

In contrast, the standard of investment value is defined in SSVS 1 as:

> The value to a particular investor based on individual investment requirements and expectations.

Further Reading

Jay E. Fishman, Shannon P. Pratt, and William J. Morrison. *Standards of Value: Theory and Applications*. (New York: John Wiley & Sons, 2007).

What's it Worth?

In the valuation professional lexicon, each buyer will estimate the "investment value" or the "acquisition value" of the target company. These value indications represent what a specific buyer would be willing to pay for a target company given

1. the buyer-specific post-merger financial projections, and
2. the buyer-specific required rate of return on investment.

The actual buyer's acquisition value for the target may be higher than—or lower than—the hypothetical buyer's fair market value for the target.

In a competitive bid for the target company, an individual buyer will likely be outbid if its acquisition price is less than fair market value. This is because other buyers will presumably bid the fair market value price or higher.

In that case, the individual buyer still made a rational offer. Because of its investment hurdle rate or some other reason, that buyer could not afford to bid the fair market value price. And, if that buyer had offered the fair market value price, then that individual buyer would have paid too much.

In a competitive bid for the target company, the successful buyer will likely offer more than the fair market value but less than its individual investment value/acquisition value. The successful buyer may have to offer more than fair market value in order to outbid the pack of other bidders.

Nonetheless, the successful buyer may not need to offer all of the acquisition price that it can "afford" to pay, given its unique acquisition risk and expected return assessment. Theoretically, the successful buyer will only need to offer $1.00 more than the next higher bidder.

In a competitive bid, each potential buyer may not know the bidding strategies of the other potential buyers. The successful buyer may have to offer most, if not all, of its acquisition value in order to ensure that it wins the bidding process. However, even if the individual buyer bids its entire buyer-specific acquisition price premium (i.e., a premium above fair market value), the buyer still made a rational offer.

Because of its unique expected synergies or some other reason, that buyer could afford to bid the price it did. If that buyer had limited its offer to hypothetical fair market value, it would have lost its bid for the target company.

In a competitive bid for the target company, the seller will typically accept the highest offer it receives. If the initial offers are less than the hypothetical fair market value, the seller will continue to shop the target company until it attracts a buyer that can afford to pay the fair market value price.

If the seller encounters an individual buyer that bids more than fair market value, the seller will reject the fair market value offers and accept the higher, buyer-specific bid.

If one buyer can afford to pay a buyer-specific price premium over the hypothetical fair market value price, the seller will certainly accept the higher price in lieu of the fair market value offers.

What Does the Transaction Price Represent?

Valuation analysts often disagree on what quantitative conclusion is the fair market value of a target company. This statement is true even if analysts

(1) all have the same information sources available to them and (2) all attempt to be as objective as possible.

Nonetheless, the important question is: Are there quantitative benchmarks that will objectively assess whether an acquirer paid more than fair market value for a target company?

The answer to the above question is yes. Before describing these objective benchmarks/criteria, it is noteworthy that paying more than "fair market value" is not the same as overpaying. It is a common misconception that paying more than the target company's fair market value implies an overpayment.

In fact, relatively few transactions are closed at the hypothetical fair market value. Many buyers rationally and consciously pay more than fair market value prices in M&A transactions.

Fair market value typically implies what a hypothetical willing buyer will pay to a hypothetical willing seller for the subject business. In a fair market value valuation, the willing buyer (and the objective analyst) theoretically considers the economic benefits of target company ownership that would be available to the marketplace.

The "marketplace" is defined as the general population of likely willing buyers. In other words, the willing buyer would ignore any buyer-specific post-merger synergies or economies of scale. That is because those economic benefits would not be available to the marketplace in general.

In a fair market value valuation, the buyer would project only those target company economic attributes available to all (or at least, most) buyers. The fair market valuation would not include any unique economic benefits created by the specific merger of the specifically identified buyer and seller.

In an actual transaction, a hypothetical willing buyer does not negotiate with a hypothetical willing seller. Rather, an actual buyer negotiates with the actual seller. An actual buyer will rationally consider all of the economic benefits of the target company from the unique perspective of that specific unique buyer.

Accordingly, each buyer will estimate buyer-specific post-merger synergies. In a synergistic M&A transaction, a specific strategic buyer may be able to benefit from the following economic synergies and post-merger benefits:[1]

- Economies of Scale: A particular consolidated post-merger company may be able to operate more efficiently than the more typical smaller companies in an industry. This operating efficiency may be due to the elimination of any redundant (1) management, (2) distribution channels, and (3) sales force.
- Financial Economies: A specific well-capitalized acquirer may be able to obtain a higher credit rating or attract a larger pool of investors than the typical potential buyer, thereby reducing its individual costs of acquisition capital below the market cost of capital.
- Increased Market Power: A specific acquirer may be able to exercise more market power than the more typical smaller companies in an industry. This buyer-specific market power may be used to raise prices and/or to negotiate better price/terms from vendors.
- Income Tax Attributes: A specific acquirer may have a particular "appetite" for the income tax attributes of the target company. These income tax attributes may include, for example, net operating loss carryforwards (NOLs).

Each specific buyer will estimate how much it can pay for the target company based on the specific buyer's costs of capital and targeted investment hurdle rate.

Each buyer considers its specific risks and expected returns when assessing how much it can afford to bid for the target company.

Objective Pricing Criteria

What are the "objective" benchmarks or criteria that determine how much an individual buyer can afford to pay for the target company—without overpaying?

First, a buyer can afford to pay a purchase price up to the amount where the acquisition internal rate of return (IRR) equals the buyer's cost of capital. If the acquisition IRR equals or exceeds the buyer's cost of capital, then the buyer did not overpay for the acquisition.

Second, a buyer can afford to pay a price up to the amount where the acquisition net present value (NPV) equals or exceeds zero. The NPV analysis is based on the buyer cost of capital.

Both of these criteria assume that the acquirer management can accurately estimate the buyer cost of capital. The buyer cost of capital should appropriately consider the risk of the investment.

Exhibit 1
Mean M&A Transaction Price Premiums Offered

For Transactions in All Industries		
Year	Mean Price Premium Paid	# of Transactions
1990	42.0%	175
1991	35.1%	137
1992	41.0%	142
1993	38.7%	173
1994	41.9%	260
1995	44.7%	324
1996	36.6%	381
1997	35.7%	487
1998	40.7%	512
1999	43.3%	723
2000	49.2%	574
2001	57.2%	439
2002	59.7%	326
2003	62.3%	371
2004	30.7%	322
2005	34.5%	391
2006	31.5%	454
2007	31.5%	491
2008	56.5%	294
2009	58.7%	239
2010	51.8%	351

Both of the above-listed criteria assume that the acquirer management can accurately project the target company economic income generation. For purposes of either criteria, the target company economic income is typically measured as net cash flow.

The application of the above two criteria may not result in a fair market value price. These criteria will result in the maximum price that the buyer can afford to pay for the target company. This maximum price will be buyer-specific, as compared to market-general.

Often, the buyer-specific maximum price for a target company will be greater than the target company fair market value. This maximum price paid for a target company can include both

1. an ownership control price premium and
2. an acquisition synergy price premium.

It is generally difficult to quantify the distinction between

1. an ownership control price premium and
2. an acquisition synergy price premium.

One reason for this difficulty is the fact that the M&A tender offer price premiums observed in the marketplace are stated as aggregate price premiums.

The valuation analyst will typically attempt to quantify the distinction between (1) an ownership control price premium and (2) an acquisition synergy price premium. To do so, the valuation analyst should identify

1. what part of an aggregate M&A price premium is attributed to ownership control only and
2. what part of the aggregate M&A price premium is attributed to expected post-merger economic synergies.

Historical M&A Transaction Price Premium Analysis

M&A transaction price premiums are compiled annually by *Mergerstat Review*. Exhibit 1 presents the *Mergerstat Review* M&A transaction price premiums in all industries for the 21-year period 1990 through 2010.

Based on the data presented in Exhibit 1, the average price premium paid over the 1990 through 2010 period was 44 percent. However, these data do not allow us to quantify the distinction between

1. the price premium paid for ownership control only and
2. the price premium paid for expected post-deal economic synergies.

In an effort to quantify this distinction, we rely on additional data compiled by *Mergerstat Review*. These additional data include observed M&A transaction price premiums paid in "going-private" transactions.

According to *Mergerstat Review*, the term "going private" refers to "an acquisition of a publicly traded company by a private investment group, individual, or a private company."[2]

The acquirer in a going-private transaction is motivated by various reasons. Some buyers are attracted to such advantages as the elimination of additional expense associated with publicly traded companies, such as shareholder documents, meetings, dividends, and compliance with numerous

Exhibit 2
Comparison of Price Premiums Paid in Strategic Buyer Transactions versus Price Premiums Paid in Financial Buyer Transactions

M&A Transaction Price Premiums Paid in Principally Strategic Buyer Deals			M&A Transaction Price Premiums Paid in "Going Private" Financial Buyer Deals		
Year	Median Price Premium Paid	# of Transactions	Year	Median Price Premium Paid	# of Transactions
1990	32.0%	175	1990	31.6%	20
1991	29.4%	137	1991	20.0%	9
1992	34.7%	142	1992	8.1%	8
1993	33.0%	173	1993	20.0%	8
1994	35.0%	260	1994	35.0%	3
1995	29.2%	324	1995	19.2%	10
1996	27.3%	381	1996	26.2%	16
1997	27.5%	487	1997	24.5%	35
1998	30.1%	512	1998	20.4%	70
1999	34.6%	723	1999	32.7%	74
2000	41.1%	574	2000	38.7%	77
2001	40.5%	439	2001	52.5%	77
2002	34.4%	326	2002	40.0%	70
2003	31.6%	371	2003	41.5%	124
2004	23.4%	322	2004	17.2%	98
2005	24.1%	392	2005	22.5%	142
2006	23.1%	454	2006	21.1%	202
2007	24.7%	491	2007	22.2%	161
2008	36.5%	294	2008	36.8%	108
2009	39.8%	239	2009	36.1%	108
2010	34.6%	348	2010	32.0%	154

SEC filing requirements. Target companies have also gone private in an effort to defend from hostile takeovers and raider/greenmail tactics.

Given the nature of going-private transactions, it is commonly believed that they include price premiums that incorporate

1. a price premium for ownership control, but not
2. a price premium for expected post-deal economic synergies.

For purposes of this discussion, we compared the reported data on price premiums paid in going-private transactions (which are representative of price premiums paid by typical financial buyers) to the data on price premiums paid in (principally) strategic M&A transactions. That is, we compared financial buyer price premiums to strategic buyer price premiums.

A summary of this price premium comparison is presented in Exhibit 2.

As presented in Exhibit 2, the median transaction price premiums paid by strategic buyers were consistently greater than the transaction price premiums paid by financial buyers—except in 2001, 2002, 2003, and 2008.

The years 2001 and 2002 present aberrations for many types of M&A and capital market analyses. This is due to the collapse of the post-dot-com "bubble."

Beginning in 2003, the M&A market was largely driven by the strength of private equity firms. Private equity firms deployed more capital and bought more U.S. companies than at any other time.

According to *Mergerstat Review*, "by the end of 2003, the U.S. M&A market saw a return of more strategic buyers, more megadeal announcements, and renewed confidence in deal-making."[3]

Exhibit 3
M&A Transaction Prices—Implied P/E Pricing Multiples

Price Premiums Paid by Strategic Buyers (in All Transactions)		Price Premiums Paid by Financial Buyers (in Going-Private Transactions)		Strategic Buyer Price Premiums vs. Financial Buyer Price Premiums (Percent Difference in Price Premiums Paid)	
Year	Median Implied P/E Multiple Paid	Year	Median Implied P/E Multiple Paid	Year	Median Implied P/E Multiple Paid
1990	16.7	1990	13.6	1990	22.8%
1991	14.0	1991	10.7	1991	30.8%
1992	18.1	1992	12.7	1992	42.5%
1993	20.0	1993	14.9	1993	34.2%
1994	20.2	1994	20.2	1994	0.0%
1995	19.1	1995	17.2	1995	11.0%
1996	20.3	1996	23.1	1996	-12.1%
1997	22.9	1997	19.9	1997	15.1%
1998	20.6	1998	17.7	1998	16.4%
1999	20.5	1999	16.9	1999	21.3%
2000	17.9	2000	12.5	2000	43.2%
2001	16.3	2001	21.1	2001	-22.7%
2002	17.6	2002	18.0	2002	-2.2%
2003	19.1	2003	16.5	2003	15.8%
2004	20.3	2004	18.4	2004	10.3%
2005	21.5	2005	22.7	2005	-5.3%
2006	22.3	2006	21.8	2006	2.3%
2007	23.3	2007	26.6	2007	-12.4%
2008	17.7	2008	23.1	2008	-23.4%
2009	16.4	2009	11.9	2009	37.8%
2010	18.4	2010	16.3	2010	12.9%
				Mean Percent Difference	11.3%
				Median Percent Difference	12.9%

Over the 2004 through 2007 period, private equity groups had a major influence on M&A activity and prices in the United States. M&A activity slowed considerably in 2008 as a result of the collapse of the U.S. banking system. This trend continued into 2009, but there was a modest recovery in 2010.

The data presented in Exhibit 2 support the conclusion that strategic buyer price premiums exceed financial buyer price premiums.

Additional data that provide insight into the differences between financial buyer price premiums and strategic buyer price premiums include the differences in M&A transaction-implied price/earnings multiples. These transactional data compare

1. the transaction price to earnings (P/E) pricing multiples paid by strategic buyers to
2. the transaction P/E pricing multiples paid by financial buyers.

These transaction data, as compiled by *Mergerstat Review*, are summarized in Exhibit 3.

As indicated in Exhibit 3, the median transaction-derived P/E price multiples paid by strategic buyers were 12.9 percent higher than the median transaction-derived P/E price multiples paid by financial buyers over the 21-year period from 1990 through 2010.

Comparisons of these transactional data suggest that there is, indeed, empirical support for the conclusion that strategic buyers are willing to pay an incremental price premium (i.e., a synergistic price premium) over and above the typical ownership control price premium that financial buyers are willing to pay.

Summary and Conclusion

Both taxing authorities and taxpayers should be cautious when using the market approach to value operating properties in a unit principle valuation. This is particularly true when the guideline merged and acquired company method is used to extract market-derived valuation pricing multiples.

This caution is due to the fact that there is the potential to overstate the value of the taxpayer's assets. This overstatement may occur if the merged and acquired company method is used without adequate consideration of what the "transaction price" truly represents. If the market-derived valuation pricing multiples represent investment value (i.e., the multiples include some synergistic premium), a value conclusion based on these pricing multiples may be greater than fair market value.

This issue is particularly important to centrally assessed taxpayers with regard to property tax assessment appeals and litigation. This issue is important. This is because M&A pricing multiples are often applied to the financial fundamentals of the subject property in order to estimate the unit value of the subject taxable assets.

Many M&A transactions (both of companies and operating properties) are strategic acquisitions. As a result, the indicated M&A transaction prices—and the resulting pricing multiples—may provide an indication of investment value rather than of fair market value.

Many M&A transactions occur at substantial acquisition synergy price premiums—when compared to fair market value price premiums. These acquisition synergy price premiums are supported by the post-merger economic synergies that are expected from the transaction.

Of course, each acquisition of a company or an operating property is a unique transaction. Accordingly, market-derived valuation pricing multiples from M&A transactions should not be used to value a subject property without an adequate understanding of

1. the terms of each transaction and
2. the particular facts and circumstances of each industry.

Notes:

1. "Mergers, Acquisitions, and Leveraged Buyouts." 2001 CFM Level II Study Guide (Downers Grove, IL: Stalla Seminars, Inc., 2001): EQ-274.
2. *Mergerstat Review* 2011 (Newark, NJ: FactSet Mergerstat, LLC, 2011): 43.
3. Ibid.: 4.

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The Role of FASB and IASB

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If the residential mortgaged-back securities are valued using the discounted cash flow method, the reporting entity will disclose the cost of capital, long-term growth rate, and operating margins it had used in the analysis.

Conclusion

For many decades, the FASB and the IASB established separate accounting standards for financial reporting. In 2011, the FASB and the IASB initiated their goal of issuing common guidance on fair value measurements.

Understanding the particular accounting standards that define fair value will provide professional guidance for corporate taxpayers, tax lawyers, and valuation analysts when applying the fair value standard of value.

Notes:

1. Stephen A. Zeff, "The Evolution of U.S. GAAP: The Political Forces Behind Professional Standards," *The CPA Journal* (2005).
2 Steven M. Bragg, *GAAP 2011: Interpretation and Application of Generally Accepted Accounting Principles*, (New York: John Wiley & Sons, 2010).
3. ASC 480 contains a provision requiring reporting entities that issue mandatorily redeemable common stock to classify these instruments as liabilities. Implementation of this provision adversely affected many privately held businesses whose common stock was subject to "buy-sell" agreements that obligated the reporting entity to redeem the owners' stock upon the event of their death. Application of ASC 480 would have required that 100 percent of these companies' equity be classified as liabilities, causing many of them to be in violation of restrictive debt covenants, or leaving them unable to obtain credit enhancements, such as guarantees, letters of credit, or surety bonds.
4. The Memorandum of Understanding was updated on September 11, 2008. On November 5, 2009, the FASB and IASB issued a joint statement, "FASB and IASB Reaffirm Commitment to Memorandum of Understanding," www.ifrs.org (accessed October 13, 2011).
5. Elizabeth A. Evans and Hong Qiao, "The Evolution of Fair Value Accounting," *Valuation Strategies* (July/August 2011): 15.

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