

The Market Participant Acquisition Premium for Fair Value Measurement

Timothy J. Meinhart

An ownership control premium is commonly applied when valuing controlling ownership interests in business enterprises for financial accounting purposes. However, there is a diversity of practice among valuation analysts (“analysts”) about how control premiums are measured and applied in fair value measurements. In an effort to develop best practices in the area of control premiums, the Appraisal Foundation issued Valuations in Financial Reporting Valuation Advisory #3: The Measurement and Application of Market Participant Acquisition Premiums (“VFR Advisory #3”). VFR Advisory #3 outlines the factors that analysts should consider when measuring and applying ownership control premiums in fair value measurements.

INTRODUCTION

Since the enactment of financial accounting guidance published in Accounting Standards Codification (“ASC”) topic 805—Business Combinations, ASC topic 350—Intangibles—Goodwill and Other, and ASC topic 820—Fair Value Measurement, there has been an ongoing requirement to properly recognize assets and liabilities at fair value in financial statements.¹

In order for financial accounting to be consistent and reliable from entity to entity, valuation analysts (“analysts”) need to provide similarly reliable analyses.

In an effort to promote quality and consistency of financial reporting, the Appraisal Foundation has issued guidance regarding best practices on certain valuation topics that are used in fair value measurements.

On September 6, 2017, the Appraisal Foundation issued Valuations in Financial Reporting Valuation Advisory #3: *The Measurement and Application of Market Participant Acquisition Premiums* (“VFR Advisory #3”).²

VFR Advisory #3 is intended to set forth best practices for certain issues that an analyst may encounter in measuring the fair value of controlling interests in business enterprises for financial accounting purposes.

This discussion summarizes the following topics, as discussed in VFR Advisory #3:

- The concept of the market participant acquisition premium (“MPAP”)
- Conceptual considerations and business characteristics that influence the MPAP
- Analytical methods for estimating the MPAP

BACKGROUND

When valuing controlling ownership interests in a business enterprise for financial accounting purposes, analysts often consider and apply an ownership control premium. Common examples of fair value measurements utilizing a control premium include the goodwill impairment test under ASC topic 350, portfolio valuation of investment companies, and the acquisition method of business combinations for certain transactions.



VALUATIONS IN FINANCIAL REPORTING VALUATION ADVISORY 3: THE MEASUREMENT AND APPLICATION OF MARKET PARTICIPANT ACQUISITION PREMIUMS



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Over the years, there has been notable inconsistency regarding the application of control premiums. In order to promote consistency and develop best practices in the area of control premiums, a working group was formed. The results of the working group are summarized in VFR Advisory #3.

VFR Advisory #3 describes the long-standing and generally accepted theory that the publicly traded price of a company's shares represents the value of a noncontrolling (or minority) ownership interest. As such, a "premium for control" should be considered when estimating the value of a controlling ownership interest, particularly when applying a publicly traded company method. However, this concept has been challenged by some analysts in the business valuation community.

VFR Advisory #3 addresses the concept that the premium an acquiror may pay over the publicly traded price of an acquisition target does not necessarily represent a price premium for merely acquiring control. Instead, the price premium reflects the expected increase in value that may be achieved by exercising control.

In other words, an acquisition price that is in excess of the target company's publicly traded price may be reasonable if the acquiror expects to increase the cash flow, increase the growth, and/or reduce the risk of the target company.

In contrast, if no such increases or risk reductions can be made, the acquiror would generally be reluctant to pay an acquisition price that is in excess of the target's publicly traded price. In such an instance, the publicly traded price may reasonably reflect the entity's control value.

VFR Advisory #3 also introduces the concept of an MPAP. The introduction of this new term was intended to:

1. emphasize the importance of the market participant's perspective when measuring fair value and
2. distinguish this price premium from the more commonly recognized, and often misapplied, control premium.

VFR Advisory #3 indicates that it is not intended to be an authoritative valuation standard. The working group drafting VFR Advisory #3 recognized that different situations often require different valuation procedures and specific facts and circumstances may support a departure from the recommendations described in VFR Advisory #3.

VFR Advisory #3 also indicates that it was developed for measuring fair value for financial accounting purposes and is not intended to be valuation guidance for other purposes.

Many analysts agree that the overall impact of VFR Advisory #3 will most likely be (1) more rigorous analyses related to control premiums and (2) a greater consistency among analysts in how control premiums are measured and applied in the context of fair value measurements.

DEFINING THE MPAP

VFR Advisory #3 defines the MPAP as the difference between:

1. the pro rata fair value of the subject controlling ownership interest and
2. its "foundation."

For purposes of this definition, "foundation" is measured with respect to the current stewardship (i.e., management) of the business enterprise.

More specifically, foundation contemplates that the prerogatives of control will continue to reside

with the existing controlling shareholder or group of shareholders.³

For purposes of VFR Advisory #3, foundation is considered to be the pro rata fair value of a marketable, noncontrolling ownership interest in a business enterprise. In the case of a publicly traded company, often this is its quoted public stock price. However, as will be discussed below, VFR Advisory #3 addresses the use of either an entity's public stock price or the entity's total invested capital as a measure of foundation.

To further explain the concept of an MPAP and its foundation, consider a business enterprise with a founder who owns and controls 80 percent of the equity. Also consider that ownership of the remaining 20 percent of the equity is fragmented with no single shareholder holding more than 2 percent of the stock. The subject entity has several available investment opportunities that would enhance the company's value. However, the controlling shareholder has chosen not to make any of these investments.

Given this set of facts, there is likely to be an MPAP that would be applied in the valuation of a controlling ownership interest in the entity. In other words, the price that may be paid by market participants for a controlling ownership interest in the company is likely to exceed the price that may be paid for a noncontrolling ownership interest that reflects the current stewardship of the company (i.e., the foundation).

According to VFR Advisory #3, the magnitude of the MPAP would be influenced by the perceived ability of market participants to exercise the prerogatives of control to increase the cash flow and/or reduce the cost of capital applicable to the subject controlling ownership interest.⁴

VFR Advisory #3 makes it clear that the analyst is responsible for identifying and evaluating the feasibility of the available value-enhancing strategies that may be implemented by market participants. In this regard, the analyst's estimate of the MPAP will consider the magnitude of the available economic benefits and the degree to which the potential benefits may influence the price that market participants may pay for the subject controlling ownership interest.

VFR Advisory #3 does not state that the potential economic benefits should be precisely quantified, but rather, an analysis should be performed to identify which form(s) of economic benefit market participants could reasonably expect to enjoy and some general magnitude of the effects of those benefits on value.⁵

In general, the authors of VFR Advisory #3 state that an MPAP should be supported by reference to (1) enhanced cash flow and/or (2) a lower required rate of return from the perspective of a market participant.

In instances where no such opportunities exist for a market participant to either enhance cash flow or lower an entity's cost of capital, the authors conclude that the MPAP is most likely minimal or nonexistent.

“[T]he analyst is responsible for identifying and evaluating the feasibility of the available value-enhancing strategies that may be implemented by market participants.”

CONCEPTUAL CONSIDERATIONS

VFR Advisory #3 provides several commonly cited examples of prerogatives of control that may be possessed by a controlling owner of a business enterprise.

VFR Advisory #3 points out that these prerogatives, such as the right to appoint a majority of the board of directors, the right to recapitalize the company, or the right to select suppliers and vendors, have only limited inherent value in and of themselves.

In other words, these commonly cited rights are merely a means through which market participants may be able to generate incremental economic benefits. For example, the right of a controlling shareholder to elect a majority of the board of directors does not necessarily convey any economic benefit to market participants unless the ability to elect the majority of the board enables the company to increase its revenue and/or lower its costs.

In this case, the expected economic benefit would potentially affect the price that would be paid by market participants and, potentially, influence the magnitude of the MPAP.

As previously described, VFR Advisory #3 states that an MPAP should be supported largely by expected economic benefits that would arise from (1) enhanced cash flow and/or (2) the lower required rates of return from a market participant's perspective.

In this regard, the analyst is tasked with identifying the economic benefits that would reasonably be available to several market participants rather than any one specific market participant (i.e., buyer).

In other words, the expected economic benefits that are available to a group of market participants are generally considered in the MPAP, but benefits available to only a single market participant are not.

In terms of economic benefits that arise from enhanced cash flow, VFR Advisory #3 notes several areas where a market participant may implement strategies that lead to increased cash flow.

These areas include, but are not limited to, the following:

- Increased revenue growth
- Increased operating margins
- Working capital efficiencies
- Capital expenditures efficiencies

Regardless of the area that leads to increased revenue or decreased costs, it is important to recognize that to be relevant in estimating the MPAP, the enhanced cash flow must be incremental to the cash flow that was expected under current company stewardship.

Stated another way, the enhanced cash flow that gives rise to an MPAP is incremental to the prospective financial information that reflects the ongoing operations of the business enterprise absent a change of control transaction.⁶

In terms of economic benefits that arise from a lower required rate of return, VFR Advisory #3 notes there are several reasons why market participants may have a lower required rate of return for a controlling ownership interest than for an otherwise identical, but noncontrolling, ownership interest under current company stewardship.

Some of these reasons include, but are not limited to, the following:

- Change in capital structure
- Economies realized through increased company size
- Reduced operating risk

While each of the above-described reasons for a lower rate of return may potentially be achieved by larger-sized market participants, VFR Advisory #3 points out that there is not a consensus among analysts regarding the relationship between (1) the size of the target company and (2) the required return from a market participant's perspective.

This is because some analysts observe that market participants use a cost of capital that is consistent with the target company size when estimating the price to pay in transactions. In contrast, other

analysts observe that market participants use a cost of capital that reflects the anticipated benefits of increased size and diversification that result post transaction.

While either measurement may be relevant when measuring fair value, it is at the discretion of the analyst to select the measurement that is most reflective of fair value. In doing so, the analyst should not assume that market participants always incorporate all anticipated economic benefits of ownership control in the price they pay for acquisitions.

Additionally, analysts should not assume that the public market has necessarily undervalued noncontrolling ownership interests.

As VFR Advisory #3 indicates, the existence of an investment analyst stock price target in excess of the stock's trading price does not provide direct evidence of the MPAP.⁷

BUSINESS CHARACTERISTICS THAT INFLUENCE THE MPAP

VFR Advisory #3 discusses several factors the analyst should consider when estimating the price market participants may pay for a controlling ownership interest and, ultimately, the MPAP.

The following discussion summarizes the factors described in VFR Advisory #3.

- Acquisition Activity in the Industry—Increased acquisition activity in a particular industry generally signals that market participants believe there are greater opportunities to generate economic benefits through change of control transactions. Increased activity may also increase the number of potential acquirors, which could increase the MPAP.
- Company's Life Cycle State—Mature companies generally present fewer opportunities for change of control acquirors to enhance cash flow or lower the cost of capital.

In contrast, growth-stage companies generally offer greater opportunities for market participants to increase revenue growth rates and improve margins. Consequently, the MPAP is generally lower for mature companies than for growth-stage companies, all else being equal.

- Market Participant Attributes—VFR Advisory #3 states that market participants are generally classified into three categories:

(1) strategic acquirors, (2) financial acquirors, and (3) conglomerate acquirors.

In estimating the MPAP, the analyst should properly identify the market participants and relate the anticipated economic benefits of ownership control to the strategies that would be employed by these potential acquirors.

- **Market Participant Size**—In many cases, market participants are significantly larger than the target company. These larger companies are often able to extract greater economic benefit from the target company than current ownership.

As a result, a larger MPAP may be appropriate for market participants that are significantly larger than the subject company.

- **Availability of Information**—There may be a difference in the information that is made available to market participants for a controlling ownership interest versus market participants for a noncontrolling ownership interest. This information asymmetry can influence the fair value of a controlling ownership interest and the magnitude of the MPAP.
- **Capital Structure of the Target Company**—The greater the opportunity to change the target company's capital structure to a more optimal mix of debt and equity, the greater the potential MPAP, all else being equal.
- **Management's Goals and Objectives**—Privately held companies are often managed with different goals and objectives than publicly traded companies. Acquirors may find greater opportunities to reduce costs and enhance cash flow in privately held companies than in publicly traded companies.

In these instances, the MPAP for a controlling interest in a privately held company may exceed the MPAP for a similar interest in a publicly traded company.

- **Quality of Management**—If the quality of the current management team is perceived by market participants to be less than optimal, there may be an opportunity to enhance cash flow through a change in management. The larger the economic impact such a change would have on the company, the larger the MPAP, all else being equal.
- **Regulatory Factors**—A company may be subject to a variety of regulatory factors,

which have a significant effect on the company's operations. These regulatory factors should be considered from the market participants' perspective when estimating their impact on the MPAP.

- **Corporate Governing Documents**—When valuing a controlling interest in a company, an analyst should review the company's governing documents for any provisions that may restrict or limit the subject interest's ability to exercise control over the company.

The magnitude of the MPAP should be correlated with the level of control that can be exercised by a holder of the subject interest.

- **Transaction Structure**—Tax characteristics and contingent consideration may have a significant influence on the price paid for a controlling business interest. Analysts should consider the influence that transaction structure has on the price paid for a business interest and the pricing multiples and control premium that are implied by the transaction.

VFR Advisory #3 states that the above-described factors, while not all inclusive, should be considered by analysts when estimating the price market participants would pay to acquire controlling ownership interests.

ANALYTICAL METHODS

VFR Advisory #3 states that the MPAP may be expressed as either (1) a dollar amount (i.e., the difference between the pro rata fair value of a controlling interest and its foundation) or (2) a percentage (i.e., the percentage premium by which the pro rata fair value of a controlling interest exceeds its foundation).

Historically, analysts have typically used the equity foundation to calculate the transaction premium as a percentage. For example, if a stock was trading at \$10 per share immediately before a \$12 per share change of control transaction was announced, many analysts in the valuation community would calculate the acquisition premium as 20 percent $[(\$12 - \$10) / \$10]$.

This way of measuring a publicly traded company acquisition premium was also consistent with the way many of the publicly available transaction databases reported the information in the past.

However, VFR Advisory #3 concluded that there is a more accurate way to express these acquisition premiums. More specifically, it concluded that calculating the MPAP as a percentage of the equity foundation is potentially misleading and it distorts the comparability of the MPAP among companies with different capital structures.

The authors suggest that an MPAP as a percentage of the total invested capital foundation may be a better way to express the MPAP percentage given that the prerogatives of control enhance the fair value of the entire business enterprise, not just the fair value of the equity.

Exhibit 1 presents an example that illustrates how transactions of similar companies at the same purchase price result in the same invested capital foundation MPAP. However, these same target companies produce a vastly different equity foundation MPAP due primarily to the difference in the leverage of the companies.

Assume the invested capital of both Alpha Company and Beta Company, on a noncontrolling interest basis, is \$100. Alpha Company has debt of \$20 and equity of \$80. Beta Company has debt of \$60 and equity of \$40.

The invested capital of both companies, on a controlling interest basis, is \$130. Under this set of assumptions, the MPAP, based on the total invested capital foundation, for both companies is \$30 (\$130 – \$100) or 30 percent. However, if we calculated the MPAP using the more traditional equity foundation, the result would be significantly different.

As presented in Exhibit 1, the \$30 MPAP for Alpha Company, when compared to its equity foundation of \$80, translates to an MPAP percentage of 38 percent. Alternatively, the \$30 MPAP for Beta Company, when compared to its equity foundation of \$40, translates to a much higher MPAP percentage of 75 percent.

As presented in Exhibit 1, 30 percent is a more accurate measurement of the MPAP percentage that was paid to acquire a controlling ownership interest in both business enterprises.

In contrast, the 38 percent and 75 percent equity foundation MPAP, while not necessarily incorrect, is largely influenced by the specific capital structure of each company.

Exhibit 1 Comparison of MPAP Percentages

	Alpha Company	Beta Company
Fair Value of Equity	\$80	\$40
Fair Value of Debt	<u>\$20</u>	<u>\$60</u>
Fair Value of Invested Capital - Noncontrolling Interest Basis (i.e., foundation)	\$100	\$100
Fair Value of Invested Capital - Controlling Interest Basis	\$130	\$130
MPAP	\$30	\$30
MPAP % Using Equity Foundation:		
MPAP	\$30	\$30
Fair Value of Equity	\$80	\$40
MPAP	38%	75%
MPAP % Using Invested Capital Foundation:		
MPAP	\$30	\$30
Fair Value of Invested Capital - Noncontrolling Interest Basis	\$100	\$100
MPAP	30%	30%

VFR Advisory #3 states that best practices include expressing and applying the MPAP on the basis of total invested capital.⁸

Various publicly available databases provide details of transactions in which buyers acquired controlling ownership interests of publicly traded companies. Many of these databases also report the transaction premium that was paid by the buyer over the publicly traded price of the target company.

Analysts have routinely used this premium data when estimating the MPAP for a valuation subject. The authors of VFR Advisory #3 caution that exclusive reliance on these observed transaction premiums of prior transactions, in most instances, is insufficient support for a concluded MPAP.

While VFR Advisory #3 states that observed historical transaction premiums may provide some evidence of the magnitude of economic benefits expected by market participants, exclusive reliance on the observed premiums is discouraged without thorough analysis of the subject transaction data and the valuation subject.

VFR Advisory #3 outlines various factors that the analyst should consider when analyzing historical transaction premium data and deciding whether such data need to be adjusted prior to their use in estimating an MPAP. Each of the following factors can have a significant effect on the premium that is observed for a given transaction.

The factors, as described in VFR Advisory #3, are as follows:

- **Size of the Interest Transacted**—The analyst should attempt to determine whether the transaction that produced the premium was of a 100 percent ownership interest or of a smaller controlling ownership interest. The size of the acquired interest and the prerogatives of control that are associated with the acquired interest may have influenced the magnitude of the observed transaction premium.
- **Financial Condition of Seller**—The analyst should research whether the acquired company was subject to financial distress. Such a situation would undoubtedly affect that price that was paid for the target company and the observed transaction premium.
- **Relationship of Buyer and Seller**—If the parties to a transaction had a preexisting relationship, it is possible that the terms of the subject transaction may not be at arm's length. In that case, the analyst should be skeptical whether the transaction can be used as a basis for supporting an MPAP.

- **Stated Rationale for Transaction**—Some transactions may be more financial in nature while others may be more strategic in nature. The analyst should research whether the transaction involved a strategic acquiror who based its purchase price on buyer-specific post-transaction synergies. Such a transaction would not necessarily be useful for estimating an MPAP.

- **Changes in Market Conditions**—Transactional data that are used in fair value measurement is usually dated months, and in some cases, years, prior to the date as of which an analyst may be making the measurement. In these situations, the analyst may need to consider changes in economic and industry-specific conditions between the time of the guideline transactions and the date of the fair value measurement.

In some situations, the analyst may choose to adjust the transaction data, or disregard the data entirely, if the business and economic conditions have changed substantially since the time of the acquisitions.

- **Stock Price and Volume Fluctuations Prior to Announcement**—In some cases, the stock price and the trading volume of a publicly traded company can fluctuate significantly prior to announcement of the company's acquisition. The analyst should review this historical data to ensure that a proper equity foundation is used in the calculation of the implied acquisition premium.

In some instances, it may be reasonable to estimate the implied acquisition premium based on the average trading price over a period of several days or weeks.

- **Transaction Structure**—Transaction structure can distort the reported price of a transaction. The analyst should make an attempt to understand the transaction structure and its impact on the transaction price prior to relying on a premium that is implied by the transaction.

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“VFR Advisory #3 is intended to provide a general framework that results in reasonably consistent and reliable fair value measurements of controlling ownership interests in business enterprises.”

- Transaction Process—The analyst should attempt to learn whether the company was sold through a robust sale process involving multiple potential buyers or whether there was a single potential acquirer.
- Transaction Status—Many transactions that are announced never close. The analyst should consider how much emphasis should be placed on the data of transactions that had not closed as of the fair value measurement date.

It may be impractical for the analyst to evaluate each of the above-described factors for all controlling interests transactions. Nonetheless, the list provides guidance an analyst should generally follow when deciding whether a transaction could be used for purposes of estimating an MPAP.

Ultimately, the analyst should evaluate the relevance of the transaction premium data by considering the comparability of the acquired companies to the subject company and whether the acquirer in each transaction is reasonably representative of a market participant.

While VFR Advisory #3 acknowledges that historical transaction premium data may be useful in fair value measurement, they caution that exclusive reliance on these data is not consistent with best practices.

VFR Advisory #3 also notes that any MPAP applied in an analysis or implied by an analysis should be the subject of a reasonableness check. The level of rigor of this reasonable check should be correlated with the level of influence that the subject MPAP has on the fair value measurement.

SUMMARY

VFR Advisory #3 sets forth best practices for certain issues that an analyst may encounter in measuring the fair value of controlling interests in business enterprises for financial accounting purposes.

VFR Advisory #3 introduces the concept of the MPAP as the difference between (1) the pro rata fair value of a subject controlling ownership interest and (2) its foundation, which can be stated on either an equity or a total invested capital basis.

The underlying premise of VFR Advisory #3 is that the MPAP should not be based exclusively on historical change of control transaction premium data. Instead, the MPAP should be supported by expected economic benefits that would arise from:

1. enhanced cash flow and/or
2. lower required rates of return from a market participant's perspective.

VFR Advisory #3 describes various business-specific factors that may influence the magnitude of the MPAP as well as transaction-specific factors that should be considered when evaluating historical transaction premium data.

VFR Advisory #3 was developed to provide guidance regarding the fair value measurement for financial accounting. However, it is not an authoritative valuation standard that must be followed by analysts in all instances.

Instead, VFR Advisory #3 is intended to provide a general framework that results in reasonably consistent and reliable fair value measurements of controlling ownership interests in business enterprises.

Notes:

1. ASC topic 805, ASC topic 350, and ASC topic 820 are the successors to Financial Accounting Standards (“FAS”) No. 141(R), FAS No. 142, and FAS No. 157, respectively.
2. The Appraisal Foundation previously issued two other documents that are meant to provide guidance on other valuation topics. The two previously issued documents are (1) Valuations in Financial Reporting Advisory #1, *The Identification of Contributory Assets and Calculation of Economic Rents* (2010) and (2) Valuations in Financial Reporting Advisory #2, *The Valuation of Customer Related Assets* (2016).
3. VFR Valuation Advisory #3: *The Measurement and Application of Market Participant Acquisition Premiums*, 10.
4. *Ibid.*, 11.
5. *Ibid.*
6. *Ibid.*, 15.
7. *Ibid.*, 18.
8. *Ibid.*, 28.

Timothy Meinhart is a managing director of the firm and the Chicago, Illinois, office director. Tim can be reached at (773) 399-4331 or at tjmeinhart@willamette.com.

