Valuation: Beyond the Basics

The Five Marketability Forces and the IRS Job Aid on S Corporations

THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL
2016 OHIO FELLOWS MEETING

April 15, 2016 – April 17, 2016

Presenter:

Fady F. Bebawy
Willamette Management Associates
Chicago, IL
ffbebawy@willamette.com.

Willamette Management Associates

Discussion Outline

- Considerations regarding how the DLOM is estimated
- The Five Marketability Forces and the DLOM
- The Five Marketability Forces and the factors considered
- How do the Five Marketability Forces work?
- The IRS Job Aid for S corporations within the Five Marketability Forces framework
- Tax-affecting or not tax-affecting
  - Comparison of the traditional valuation method and the IRS Job Aid valuation method
- Concluding Comments

How the DLOM is Estimated

- Traditional sources for the DLOM
  - Restricted stock studies – 20 studies dating back to the late 1960s
  - Pre-IPO studies – Three main studies covering over 50 years of transaction data dating back to the late 1970s
- *Mandelbaum* Factors – Nine subjective, qualitative considerations:
  - Financial statement analysis
  - Dividend history and policy
  - Nature of the company, its history, its position in the industry, and its economic outlook
  - The company management
  - The amount of control in the transferred shares
  - The restrictions on transferability
  - The holding period for the stock
  - Subject company's redemption policy
  - Costs associated with a public offering

How the DLOM is Estimated

- Lack of support for the DLOM estimate
  - IRS and courts have been critical of DLOMs because of the perceived lack of support for the DLOM estimate
  - From a wide range of 15% to 50% to a point estimate
- Attempts to customize the analysis – Restricted stock studies
  - FMV Restricted Stock Study database
  - Pluris DLOM Database
- Attempts to customize the analysis – Pre-IPO studies
  - Valuation Advisors, LLC, pre-IPO database
- Continued lack of support for the DLOM estimate
  - IRS and courts continue to be critical of DLOMs because of the continued perception of a lack of support for the DLOM estimate
  - From a more narrow range (that is 10% or 15% wide) to a point estimate

The Five Marketability Forces and the DLOM

- Bridging the Gap – Five Marketability Forces Framework
  - Taken from Michael Porter's Five Forces model to evaluate a company's competitive position in the marketplace
  - Article appeared in the January 2016 Special Section: Valuations issue of *Trust & Estates*
- The Five Marketability Forces
  - Supply Marketability Force
  - Demand Marketability Force
  - Substitutes Marketability Force
  - Turnover Marketability Force
  - Competition Marketability Force
- Supply Marketability Force – How easy is it that the noncontrolling interest can be made available (supplied) to the marketplace?
  - Different than the five forces where supply relates to the number of suppliers in the marketplace
  - The greater the ease to supply, the lower the DLOM

The Five Marketability Forces and the DLOM

- Demand Marketability Force – How attractive is the noncontrolling interest as an investment to hypothetical investors vis-à-vis other investments available to them?
  - The greater the demand, the lower the DLOM
- Substitutes Marketability Force – How many investments are in the marketplace that can be a substitute to the noncontrolling subject interest?
  - The greater the number of substitutes, the greater the DLOM
- Turnover Marketability Force – What macroeconomic and/or regulatory risk does the noncontrolling interest's company face that would make it a more risky or a less risky investment than other investments?
  - The greater turnover or risk, the greater the DLOM
- Competition Marketability Force – Overall competition among investments that are comparable to the noncontrolling interest

The Factors of the Five Marketability Forces

The Five Marketability Forces

Competition

Investment Concentration

Supply	Demand	Substitutes	Turnover
Withdrawal	***Voting Rights***	Substitute Investments	Macro Economy/Market Risk
Transferability	Make Business Decisions	Size	Regulatory Environment/Market Risk
Put Rights	Access to Information	***Percentage Ownership***	
Stock Redemption Policy	***Distribution Policy***		
Time to Liquidity	Financial Profitability/ Business Risk		
	Management Quality/ Business Risk		
	Historical Transactions		
	IPO Probability		
	Volatility		
	Number of Potential Buyers		

Note: Factors that can be influenced by estate attorneys and set in the estate plan are in red bold italics.

How the Five Marketability Forces Work

(example for illustrative purposes only, please note this example is not based on an actual case, do not rely on this example as a reference)

- Start with the traditional analysis:
  - Traditional sources DLOM range – 15% to 50%
  - Customized sources DLOM range – 30% to 40%
- The Five Marketability Forces – An example
- Assignment of each force – At the high end or +5%, at the midpoint or +0%, or at the low end or -5%
  - Supply – plus 5%
  - Demand – plus 5%
  - Substitutes – plus 0%
  - Turnover – minus 5%
  - Competition – plus 0%

How the Five Marketability Forces Work

(example for illustrative purposes only, please note this example is not based on an actual case, do not rely on this example as a reference)

- Weighting of each force from 1 to 3 – A low weight or 1, a medium weight or 2, and a strong weight or 3
  - Supply – strong or 3
  - Demand – strong or 3
  - Substitutes – medium or 2
  - Turnover – low or 1
  - Competition – medium or 2
- Weighted average equals 8%
- Estimated DLOM
  - Equals 30% (the low end of the customized sources range)
  - Plus 8% from the Five Marketability Forces framework
  - Equals 38%

How the Five Marketability Forces Work

(example for illustrative purposes only, please note this example is not based on an actual case, do not rely on this example as a reference)

Inputs					
DLOM Range [a]		30%	to	40%	
FMF Range [b]		0%	to	10%	
Starting DLOM (Midpoint) [c]			5%		

	The Five Marketability Forces				
	Supply	Demand	Substitutes	Turnover	Competition
Assignment of Force [c] (-5%, 0%, +5%)	5%	5%	0%	-5%	0%
Weight (1=Low, 3=Strong)	Strong 3	Strong 3	Medium 2	Low 1	Medium 2
Weighted Average FMF Rate			8%		
Low End of DLOM Range			30%		
Concluded DLOM			**38%**		

[a] The DLOM range is the result of the customized DLOM analysis.

[b] The FMF range considers the low end of the DLOM range as 0% and the high end of the range as the difference between the low and high of the DLOM range.

[c] The starting DLOM (midpoint) is the starting point of the FMF range. Each force is assigned a score of either -5%, 0%, or +5%. For example, a -5% score for just one force (ignoring all other forces) would result in a 0% along the FMF range and a 30% along the DLOM range.

The IRS Job Aid and the Five Marketability Forces

- Suggests some factors that may be considered in adjusting for S corporation status
- Pool of hypothetical willing buyers – There would be fewer buyers so this would increase the DLOM
  - In the Five Marketability Forces framework, this factor would fall under the demand marketability force
- Economic interests of the hypothetical seller
  - In the Five Marketability Forces framework, this factor would fall under the supply marketability force
- Actual revenue and expenses of the S corporation entity
  - In the Five Marketability Forces framework, this factor would fall under the supply marketability force

The IRS Job Aid and the Five Marketability Forces

- Availability of equity and debt capital to the entity – The suggestion is that it may be more difficult to raise debt and equity because of the S corporation status (limit number and type of investor, limit to one class of stock, limit of straight debt) and this would result in a higher DLOM.
  - However, the Job Aid then states that these limitations may not differ materially from other entities that have not made the S corporation election. This would have no impact on the DLOM.
  - Debt or equity financing providers may positively view the tax advantage of S corporations as something that would increase the financial position of the company, all other variables held constant. This would then lower the DLOM rather than increase it.
  - In the Five Marketability Forces framework, this factor would fall under the demand marketability force.

The IRS Job Aid and the Five Marketability Forces

- Likely holding period of the noncontrolling interest – holding period would be longer and, therefore, the DLOM would be higher.
  - In the Five Marketability Forces framework, this factor would fall under the demand marketability force.
- These factors are logical and could certainly be considered in estimating a DLOM, but they do not have any impact on the tax status of the company.
  - In other words, these factors are already being considered in the traditional valuation analysis in which the cash flow is tax-affected and adjusted for the pass-through benefit.
- The question is, do these additional considerations really get to the same place as tax-affecting and adjusting for the S corporation pass-through characteristic?

Tax-Affecting or Not Tax-Affecting

(example for illustrative purposes only, please note this example is not based on an actual case, do not rely on this example as a reference)

- Hypothetical S Corporation Example
  - Revenue of $1 million
  - Operating margins of 25%
  - Tax rate of 35%
  - Long-term growth rate of 3%
  - Debt value of $200,000
  - Capital structure of 75% equity/25% debt
  - Discount rate – after-tax of 10.6%
  - Discount rate – pre-tax of 16.3%

Tax-Affecting or Not Tax-Affecting

(example for illustrative purposes only, please note this example is not based on an actual case, do not rely on this example as a reference)

- Comparison of the traditional valuation method and the IRS Job Aid valuation method
- Traditional valuation method – Tax-affect the earnings and adjust for the pass-through entity (PTE) tax benefit, applying an after-tax discount rate to after-tax cash flow
- IRS Job Aid valuation method – Do not tax-affect earnings and do not adjust for the PTE tax benefit; use after-tax discount rate on pre-tax cash flow
- Corrected IRS Job Aid valuation method – do not tax-affect earnings and do not adjust for the PTE tax benefit, use pre-tax discount rate on pre-tax cash flow

Tax-Affecting or Not Tax-Affecting

(example for illustrative purposes only, please note this example is not based on an actual case, do not rely on this example as a reference)

	Traditional Valuation Method	IRS Job Aid Valuation Method	Change	Percent Change	Corrected IRS Job Aid Valuation Method	Change	Percent Change
Business Enterprise Value	2,403	3,732	1,330	55%	2,167	(236)	-10%
Equity Value	2,203	3,532	1,330	60%	1,967	(236)	-11%
PTE Adjustment (SEAM)	1.21	1.00			1.00		
FMV of Equity, before DLOM	2,665	3,532	867	33%	1,967	(698)	-26%
DLOM	35%	35%			35%		
FMV of Equity, after DLOM	1,732	2,426	694	40%	1,408	(324)	-19%
DLOM (Parity)	35%	**51%**		16%	12%		-23%
FMV of Equity, after DLOM (Parity)	1,732	1,732			1,732		

PTE = Pass-through entity

SEAM = S corporation economic adjustment model

FMV = Fair market value

Tax-Affecting or Not Tax-Affecting

(example for illustrative purposes only, please note this example is not based on an actual case, do not rely on this example as a reference)

- Comparison Results: IRS Job Aid value is higher than the traditional valuation method
  - Business enterprise value is higher by 55%
  - Equity value is higher by 60% (changed because of the fixed level of debt)
  - FMV of equity is higher by 33% (changed because of the PTE adjustment)
  - FMV of equity after 35% DLOM is higher by 40%

Tax-Affecting or Not Tax-Affecting

(example for illustrative purposes only, please note this example is not based on an actual case, do not rely on this example as a reference)

- FMV of equity with the IRS Job Aid valuation method implies a 51% DLOM to arrive at the same FMV of equity after DLOM using the traditional valuation method
  - In other words, is it reasonable that the factors related to the S Corporation status would result in an additional DLOM of 16% to arrive at a total DLOM of 51%?
    - Would the courts accept this additional DLOM?
  - Shouldn't these factors already be included in the DLOM using the traditional valuation method (tax-affecting and PTE adjusting)? Yes!
- There is an inherent disconnect between applying an after-tax discount rate to pre-tax earnings

Tax-Affecting or Not Tax-Affecting

(example for illustrative purposes only, please note this example is not based on an actual case, do not rely on this example as a reference)

- Comparison Results: Corrected IRS Job Aid value is lower than the traditional valuation method (corrected to apply a pre-tax discount rate to pre-tax cash flow):
  - Business enterprise value is lower by 10%
  - Equity value is lower by 11%, it's different because of the fixed level of debt
  - FMV of equity is lower by 26%, because of the PTE adjustment
  - FMV of equity after 35% DLOM is lower by 19%
  - FMV of equity parity requires a 12% DLOM to arrive at the same FMV of equity after DLOM

Tax-Affecting or Not Tax-Affecting

(example for illustrative purposes only, please note this example is not based on an actual case, do not rely on this example as a reference)

- Note that the PTE adjustment factor of 1.21 or 21% indicates that the traditional valuation method adjusts C corporation values by 21% to arrive at a S corporation value. In other words:
  - Willing buyers would pay a premium of 21% over the C corporation value
  - Willing sellers would receive a premium of 21% over the C corporation value

Tax-Affecting or Not Tax-Affecting

- The IRS Job Aid cites an "evidence-based analysis utilizing a real-world data set." (IRS Job Aid, Appendix C, page 32)
  - In Merle M. Erickson and Shiing-wu Wang, "Tax Benefits as a Source of Merger Premiums in Acquisitions of Private Corporations," *The Accounting Review*, Vol. 82, No. 2, pp. 359-387 (2007)
- "Based on the transactions analyzed, Erickson and Wang concluded that the average tax benefits available to a buyer of an electing S Corporation are in the range of 12% to 17% of the overall value of the deal." (IRS Job Aid, Appendix C, page 33)
- "These benefits will likely result in negotiated purchase price premiums in the range of 10% to 20% of basic deal value, depending upon the specific facts and circumstances and the negotiating strengths of the parties." (IRS Job Aid, Appendix C, page 33)

Tax-Affecting or Not Tax-Affecting

- "The authors conclude that controlling interests in S Corporations are more valuable on average than **similar interests in equivalent C Corporations** in a range of 10% to 20% of value." (IRS Job Aid, Appendix C, page 15)

Concluding Comments

- The IRS Job Aid cites seven cases that support the IRS' position to not tax-affect earnings.
- Generally, the valuation community, since the *Gross* case in 1999, has continued to tax-affect earnings and adjust for a PTE tax benefit.
- Many cases that applied the tax-affect have been challenged by the IRS and settled, so we don't know much about them.
- In many of the cases that settled, the traditional valuation method related to tax-affecting and adjusting for the PTE tax benefit was **accepted**.
- The IRS decides which cases to try and which to settle based on its chances of winning.
  - It does not want to lose cases and have a precedent supporting tax-affecting and PTE adjusting.

Fady F. Bebawy

Fady F. Bebawy is a vice president with Willamette Management Associates. In addition to his work on all types of valuation and forensic analysis engagements for the firm, he is also the leader of our commercial damages analysis services practices.

Fady has provided financial consulting services for over 20 years and has performed business valuation and litigation consulting for the past 12 years. He frequently provides business and succession planning valuations, acquisition purchase price allocation valuations, goodwill impairment analyses, restricted stock valuations, waterfall analysis of companies with a complex capital structure, reasonableness of compensation analyses, transfer price analyses, merger and acquisition valuations, fairness opinions, solvency opinions, commercial economic damages analyses, and employee stock ownership plan (ESOP) employer stock valuations.

Fady holds a BA in accounting from New York University and an MBA in finance from Booth Graduate School of Business at the University of Chicago.

Fady is a Certified Management Accountant with the Institute of Management Accountants. He is also a member of the Business Valuation Association of Chicago.

Prior to joining Willamette, Fady was a vice president at BDO Valuation Advisors and at Duff & Phelps. He also worked for Huron Consulting Group, Arthur Andersen, and J.P. Morgan Securities, Inc.

Fady can be reached at (773) 399-4323 or at ffbebawy@willamette.com.