



Comparative Value Analysis

Business valuation reports often make reference to the following types of analysis collectively referred to as 'comparative value analysis':

- analysis of financial ratios and multiples calculated (using publicly available data) for so called 'comparable companies', whereby the objective is to provide an indication as to value and price relationships and rates of return sought by public market participants; and
- analysis of recent transactions that have taken place where the acquired company is a so called 'comparable company', whereby the objective is to provide some indication of rates of return required by corporate acquirers and, in some cases, the extent of post-acquisition synergies perceived within a given industry.

As a practical matter and as a general rule, only in very limited circumstances can the results obtained from a comparative value analysis be directly applied, other than as a possible 'test of value' otherwise determined, to a subject company for the purpose of rendering an opinion as to the fair market value of its outstanding shares or assets. Accordingly, valuation reports placing a primary reliance on comparative value analysis generally should be looked upon with caution.

Normally, the results of a comparative value analysis are only useful in assessing the overall reasonableness of an opinion or estimate of fair market value derived pursuant to a cash flow based valuation methodology (i.e. capitalization of discretionary cash flow or discounted cash flow methodology) or (in some limited circumstances) an asset based valuation methodology.

Application of comparative value analysis

The key ratios or valuation multiples commonly analyzed in a comparative value analysis include:

- financial operating ratios regarding liquidity, financial and operating leverage, profitability and efficiency;
- equity value to:



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- ✓ earnings,
- ✓ discretionary cash flow,
- ✓ book value, and
- ✓ net tangible assets;
- enterprise value to:
 - ✓ revenues,
 - ✓ EBIT-DA, and
 - ✓ EBIT; and
- for certain industries, ratios such as enterprise value per dollar of revenue, per unit of capacity, per customer or some other performance or value indicator commonly used by acquirers or stock market analysts in those industries.

The purpose of this analysis is to assess value relationships and to assist in determining appropriate rates of return to apply when determining a reasonable range for the fair market value of the shares or assets of the subject company. The ratios and multiples generally are derived from stock market data and public financial disclosures of so-called comparable publicly traded companies and, where it exists, data from recent open market transactions involving so called comparable companies.

Available data on so called comparable companies is usually limited and does not typically include the detailed cash flow forecasts utilized to generate the value / price decision either in a public market context or in the context of recent open market transactions. Without firsthand participation in the underlying negotiations of recent open market transactions, it generally is not possible to isolate those components such that a measurement of the degree of conservatism or aggressiveness in the cash flow projections to which capitalization techniques were applied can be made. Without this key knowledge, determination of the actual discount rate or capitalization rate implied in any particular transaction price or publicly traded stock price generally is not possible.



Limitations of comparative value analysis – public equity market data

As a general rule, at any given point in time public equity markets record public expectations of both general economic and specific industry conditions through both broad, and industry specific, market indices. These general indications are often used as benchmarks in developing values for both privately-held businesses and publicly-held companies. However, at any point in time the intrinsic value of the shares traded on public markets of any particular company may be less than, greater than, or equal to the price at which they trade.

The use of so-called 'comparable' public market multiples is a popular technique among stock market analysts preparing research reports and stock recommendations. These analysts tend to identify a public company's peer group of publicly traded companies and assess why the stock being analyzed should trade at a higher or lower multiple of earnings (or some other measure) than its peers. While public equity market data may lend itself relatively well to that purpose, there are numerous fundamental differences between share prices as indicated in the public equity markets and the market for all of the outstanding shares or net operating assets, or for control of, a given privately-held business or publicly held company. In particular:

- public market participants have a wide range of time horizon objectives (from a few minutes to many years), whereas purchasers of a controlling interest in either a public or private company tend to be long term holders. This has become all the more evident in the current volatile securities markets, where the Internet has facilitated (and likely will exacerbate, at least in the near term) rapid growth of 'day trading', a flow of investment monies from so-called 'old economy' companies to so-called 'new economy' (i.e. 'technology' and 'e-commerce') companies, and so-called near-term 'momentum trading'. Acquirers with a long term perspective are generally less influenced by near-term fluctuations in the stock and money markets compared to those with a short term perspective;
- stock prices can fluctuate erratically within a short time period based on investor sentiment in the market place. In general, en bloc value in a notional market sense and en bloc price in an open market transaction tend to reflect a greater level of stability;
- there may be significant differences in the degree of liquidity. Shares of widely held public companies enjoy a high level of liquidity, particularly in comparison to a thinly traded stock or a large block of shares that the market may not be able to readily absorb. The liquidity of a controlling interest in a publicly held or privately-held company can vary considerably depending on the nature of the industry and the company itself. Where a control position in a public or private company is believed to be less liquid compared with normal-sized trading lots of publicly held company shares this reduced degree of liquidity arguably may impact the perceived level of risk and resultant required rates of return – although we believe the better view of this is that the market for a normal trading block in any given public company is



simply different than the private market for 100% of the shares or control of privately-held companies;

- public equity market data represents normal sized lots of public company share trading prices. As a result, the transactions are those that take place between minority shareholders. Whether or not such trading prices reflect a discount either for non-control or illiquidity (in the case of thinly traded stocks) usually is not evident;
- stock market transactions are generally consummated based on publicly available information which at any given point in time typically does not include important strategic and other 'insider' information not disclosed by the company. Typically, a greater amount, if not all, of such data is available in both an en bloc private company notional market valuation and open market transaction (e.g. near and long term strategies, detailed operating plans and forecasts, and so on) pursuant to the due diligence review conducted in such exercises. Such additional information usually has a significant bearing on risk assessment, company prospects and required rates of return; and
- an open market transaction is generally characterized by lengthy negotiations between sophisticated parties which negotiations ultimately have an influence on price. This is not the case in a stock market transaction where the parties to the transaction seldom directly interact, act on such things as 'perceived market or particular stock momentum' and, in the case of normal sized trading lots, rarely have a significant impact on price.

As a practical matter, the usefulness of specific public company financial statistics and public market trading prices in developing values for (particularly) small and medium sized private companies – say, those with revenue under \$50 million - varies directly with the size of the privately-held business and the industry in which it operates. Stated differently, the smaller the privately-held business, the less likely it is that such information will prove useful. In addition, differences may relate to the fact that public companies (particularly older, well established ones in mature industry sectors) generally are:

- larger, often significantly so, than companies that are privately-held;
- either vertically or horizontally integrated, although this is not always the case. Small and medium sized privately-held companies tend not to be vertically or horizontally integrated;
- spread over a broader geographical area than are small and medium sized privately-held companies;



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- more fully developed than most small and medium sized privately-held companies from the point of view of such things as management, financial stability, product development, and strategic planning;
- directed by management groups which:
 - ✓ focus to some degree on earnings from the point of view of the influence of earnings on share price which in turn relates to the public market financing ability and cash flow, as contrasted with small and medium sized private company management which tends to focus on cash flow and looks at earnings from the focus of income tax liability,
 - ✓ frequently have greater depth and strength than is the case with most small and medium sized privately-held companies, whose management generally tends to less regimented, more entrepreneurial, more direct 'personal reward' oriented, less strategic, and more personally identified with the business, and
 - ✓ gear income tax planning corporately, and typically without consideration for the private tax planning of corporate shareholders. Owners of privately-held companies frequently gear income tax planning on a composite personal/corporate basis, with the prime consideration being to minimize income tax on a personal level. Therefore, as compared with private companies, public companies may pursue more aggressive accounting policies (such as capitalizing minor items); and
- generally are capable of accessing a larger number of funding sources with greater resources than are small and medium sized privately-held companies. As a result, companies whose shares are publicly traded often have a lower cost of capital than do such privately-held companies.

The degree to which companies deemed comparable are used in any particular valuation will vary depending on the type of company and the ability and expected benefit of performing comparative value analysis. As a practical matter, for small and medium sized private companies, it is usually difficult, if not impossible, to find a truly 'comparable' public company. Notwithstanding, some comparative value analysis may be helpful as a 'reasonableness test' of the overall valuation conclusion if information with respect to the so-called 'comparable companies' is available such that it is believed such a comparison is useful.



Limitations of comparative value analysis - industry transactions

When completing an en bloc notional market valuation it is usually beneficial to identify and analyze recent transactions where the acquired company is considered to be a so called 'comparable company'. The identification and analysis of such transactions may provide insight as to:

- the relative degree of liquidity in a given industry. Where an industry has experienced numerous recent transactions and is believed to be going through a consolidation phase, liquidity may be enhanced at this point in time which, all other things being equal, has an upward influence on value and price;
- the perceived risks and rates of return of corporate acquirers. Depending on the parties involved, there may be sufficient information regarding the transaction to obtain some understanding of the valuation parameters used by companies in the industry; and
- the most likely buyers and post-acquisition synergies that might be expected.

In an open market transaction, recent transactions may assist to varying degrees when estimating the price range competitors might bid for a company that is being tendered based on an analysis of their previous acquisition activity and that of their competitors.

Although data derived from an analysis of comparable companies may provide such insights, its direct application to any particular en bloc notional market valuation or open market transaction is rarely possible because:

- sufficient information is normally not available to fully understand the valuation dynamics of the company being acquired. This includes company plans, the segregation of non-evident redundant assets, undisclosed liabilities, and so on. As a result, the level of disclosure of open market transactions is generally insufficient to formulate concrete conclusions regarding rates of return that can be applied to a given subject company in a notional market valuation or open market pricing exercise. The quantity and quality of disclosure is particularly restricted where the vendor or purchaser or both are privately-held companies;
- each open market transaction is conducted under a unique set of circumstances and in the end the price paid and consideration received are a function of both vendor and purchaser negotiating skills and bidding competition; and
- an open market transaction is normally comprised (either implicitly or explicitly) of consideration of the perceived intrinsic value of the acquired firm plus, in many cases and in varying degrees, purchaser-perceived post acquisition synergies. Therefore, even where



sufficient information exists to compute earnings and cash flow multiples in an acquisition, in the absence of direct involvement with the purchaser, it is unusual that the underlying value components can be segregated.

The application of multiples from open market transactions is further complicated where all or part of the consideration paid involves a non-cash component such as shares of the acquirer, vendor take-backs or so-called 'earn-out' arrangements. Where this is the case, a cash equivalent price should be estimated for purposes of comparison. Unfortunately, in many cases, sufficient detail regarding the fair market value of the non-cash components is not readily available or determinable. Further, where the open market transactions being analyzed are not recent, important changes in the industry and economic factors during the interim period must be considered.

Sometimes within an industry group there have been enough open market en bloc acquisitions and enough publicly available information with respect to them, that useful data is available. For example, in Canada at any given time these circumstances may exist in government regulated industries such as the securities industry, the cable television industry, and the broadcast industry. However, even within such industry groups, primary reliance on so-called comparable transactions generally is fraught with difficulties.

Observations with respect to reliance on open market transaction data

Each open market transaction involves a unique set of circumstances and vendor and purchaser motivations. Therefore, in the absence of active participation in an industry transaction, it is seldom possible to obtain the details necessary to formulate firm conclusions regarding the basis upon which the implicit multiples were derived. As a result, the use of data derived from an analysis of comparable industry transactions at best generally is limited to aiding in gaining an overview understanding of the risks and rates of return of a particular industry and in evaluating the reasonableness of valuation / pricing conclusions derived pursuant to a cash flow based valuation methodology.

Transactions involving the subject company

Acquisition of control in the subject company

In some cases, the company being valued or priced may have been the subject of an arm's length acquisition of control in its recent history. Where this is the case, the details surrounding that transaction should be analyzed to determine what the purchaser perceived to be the risks



and potential of the business at that time. Such an analysis must take into account at least the following things that might have a material impact on the degree of comparability:

- changes to the company during the interim period. This might include changes in size, levels of profitability, products or services offered, and so on. In particular, following an acquisition, a company may experience changes in its management team and business strategy which would make any comparison less valid;
- changes in the industry during the interim period. Since the previous transaction, there may have been significant developments regarding the competitive environment, advancements in technology, and so on; and
- the economic environment at the time of the prior transaction, including prevailing rates of return at that time and changes since then.

Acquisitions of minority interests in the subject private company

Where there have been recent sales, or a history of sales, of minority shareholdings of a privately-held company, useful information sometimes can be gleaned which might aid in the determination of the value of a particular minority shareholding in the same company. However, in this regard, at least the following things must be considered:

- the basis by which prior prices were established;
- the parties transacting, whether they were acting at arm's length, and what their motivations were when transacting;
- the percentage interest the minority share bloc that was acquired represented;
- how informed the buyer and seller were as to the then current financial and other affairs of the company and the prospects for the company at that time;
- whether the transaction was funded utilizing company funds or external funds and whether there was an element of company-sponsored financial assistance present in any of the transactions;
- whether there any contractual agreements governing the basis upon which the transactions were effected, particularly whether there was a shareholders agreement that addressed the issue of 'value'; and



- the changes that have occurred in the prospects for the business, the industry in which it operates, and the economy between the dates of prior transactions and the valuation date.

Where such things are capable of analysis, it may be possible to adjust prior sales of minority shareholdings, thereby assisting in the determination of the value of a given minority shareholding.

Acquisitions undertaken by the subject company

Where the subject company has acquired other companies within its industry, the transactions should be analyzed. In particular, such transactions might provide an indication as to the subject company's target rates of return and level of synergies anticipated in industry transactions. As in all cases, caution must be employed when evaluating such transactions, particularly with respect to the degree of comparability between the acquirer and acquiree. In particular, in comparison to the acquirer, the acquiree might:

- be considerably smaller in size, and not enjoy the same economies of scale;
- have a different financial position, and be subject to a different degree of financial risk;
- have one or more key employees who may or may not be retained pursuant to a management contract or are subject to a non-compete agreement; and
- participate in different markets, with different products, and so on.

In addition, it is possible that the acquirer was successful in its acquisition bid because it overpaid for the acquiree. In circumstances where that was the case, to apply the same multiples when developing the value or price of the shares (or net assets) of the acquirer would not provide a sound basis for determining said value or price.