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Guideline Public Company Method and Control Versus Minority Value Conclusions

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Background

- When applying the guideline public company method, the typical view has been that resulting value is always a minority, marketable value, or a control value, depending on what we believe we are observing in the public peer group.
- The most traditional point of view states that a single share in a public company represents a minority position that is readily marketable. Therefore applying public peer group multiples results in a minority marketable value for the subject interest
- The alternate view states public companies trade at or near control values. If management engages in abusive discretionary spending or over-compensation practices, there is pressure from shareholders and the board to discontinue these and maximize shareholder returns. Therefore applying public peer group multiples results in a control value for the subject interest

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Control Premiums and Minority Discounts

- The concept I would like to introduce today is that regardless of what we believe we are observing with the peer group, we can in many cases derive either a control or a minority, marketable value *directly* through the Guideline Method.
- The basis of this presentation is that it is preferable whenever reasonably possible to derive a control or minority marketable value directly through the valuation technique (without the use of premiums or discounts)



Control Premiums and Minority Discounts

- Why might this be a better conceptual approach?
 - Use of control premiums and discounts assumes the “average” control / minority value gap always applies to every company. In reality it can be very large or zero depending on how the company is run. Selection of this discount is very subjective.
 - At the 2004 AICPA conference on current SEC and PCAOB developments, the SEC stated that the rationale for using (valuation) discounts should be supported by objective and reliable information. While discussing type and magnitude with respect to discounts, the SEC Staff said that a lack-of-control discount is inappropriate unless a company can demonstrate disproportionate returns to a controlling shareholder, which companies generally cannot do.



Control Premiums and Minority Discounts

- Why might this be a better conceptual approach?
 - Mergerstat Review studies likely reflect primarily perceived acquirer synergies rather than control premiums.
 - Shannon Pratt states “Most acquisitions of public companies include some premium for synergistic value over and above a pure premium for control, and it is hard to sort out the synergistic versus the pure control portion of the premium paid.”
 - Pratt also states “It has been well documented on balance that far more company sales are overpriced than underpriced, this is often because of buyer’s overestimation of synergies between the buying company and the selling company.”
 - There are numerous university studies that document that in most acquisitions, the buyer overpays for the target company and rationalizes synergies that do not materialize after the transaction.



The Guideline Public Company Method

- What are we observing in public company market capitalizations?
 - The Traditional View – We are observing minority, marketable values.
 - This presumes that a control owner could enhance the benefit stream (cash flows) currently accruing to the minority owners, and therefore there is a value gap between a control and minority value.
 - Said another way, the current benefit stream accruing to the owners of the company is not maximized, it is a minority benefit stream.



The Guideline Public Company Method

- What are we observing in public company market capitalizations?
 - The Alternate View – We are observing control values.
 - This presumes that a control owner could not materially enhance the benefit stream (cash flows) currently accruing to the minority owners, and therefore there is effectively no value gap between a control and minority value.
 - Said another way, the current benefit stream accruing to the owners of the company is near maximized, it is a control benefit stream.



The Guideline Public Company Method

- What are we observing in public company market multiples?
 - Observed minority value = observed minority benefit stream
 - Derived peer group multiple is the relationship between a minority value and a minority benefit stream
 - Observed control value = observed control benefit stream
 - Derived peer group multiple is the relationship between a control value and a control benefit stream



The Guideline Public Company Method

- What are we observing in public company market multiples?
 - Example Minority Company:
 - Market capitalization + interest bearing debt = \$100 million
 - Last twelve months EBITDA = \$10 million
 - Enterprise Value / EBITDA multiple = 10x
 - Example Control Company:
 - Market capitalization + interest bearing debt = \$150 million
 - Last twelve months EBITDA = \$15 million
 - Enterprise Value / EBITDA multiple = 10x



The Guideline Public Company Method

- Valuation multiples are just inverted discount rates right?
- Are control and minority discount rates different?
 - Shannon Pratt states “whether an income approach produces a minority or control value depends primarily on the nature of the cash flows being discounted rather than the discount or capitalization rate being applied”
 - Ibbotson has stated “Investors will not accept a lower rate of return for minority interests than for controlling interests”
 - So in practice, market derived discount rates are presumed to be neutral (the same) with respect to control versus minority interests.



The Guideline Public Company Method

- And now the BIG question:
 - If an income approach with *minority forecasted benefit stream* discounted by a market rate of return results in *minority value*.
 - And an income approach with a *control forecasted benefit stream* discounted by the same market rate of return results in *control value*.
 - And observed market multiples are simply inverted market rates of return.....
 - **Does this not then mean that observed public company multiples should be the same regardless of whether we are observing a control or minority value?**



The Guideline Public Company Method

- Conclusion
 - If guideline public company multiples are the same irrespective of whether we are observing minority or control values in the marketplace then:
 - If we apply these multiples to a control benefit stream for our subject company we get a control value
 - If we apply these multiples to a minority benefit stream for our subject company we get a minority marketable value
 - This principle is not any different than what is currently widely applied in practice for income approaches!



The Guideline Public Company Method

- Conclusion
 - Example: Observed market Enterprise Value / EBITDA multiple = 10x
 - Our subject company has a minority (unadjusted for control) EBITDA for the last twelve months of \$500,000.
 - We apply the 10x multiple and we get a minority value of \$5 million.
 - We review the subject company's operations and determine that a control owner could limit current management overcompensation, discontinue spending for travel that does not support core business operations. Based on these adjustments, control EBITDA for the last twelve months would have been \$650,000.
 - We apply the 10x multiple and we get a control value of \$6.5 million.



The Guideline Public Company Method

- Exceptions to the rule:
 - There are some places where this method of directly deriving a control or minority value through a Guideline method is not feasible:
 - The benefit stream is not closely related to distributable cash flow – for example the benefit stream is revenue instead of gross cash flow, earnings, or EBITDA.
 - The issue is that a benefit stream such as revenue may not vary between control versus minority owners, but the resulting cash flows to control versus minority owners could still be highly disproportionate.



The Guideline Public Company Method

- QUESTIONS?

