

Estate Planning Valuation Insights

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VALUATION ADJUSTMENTS (DISCOUNTS AND PREMIUMS) IN BUSINESS/STOCK VALUATIONS FOR ESTATE PLANNING OR ESTATE TAX PURPOSES

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Systematic and nonsystematic valuation adjustments can be either decremental (called valuation discounts) or incremental (called valuation premiums). Systematic adjustments are discounts or premiums that affect business and security valuations across the board—such as level of value adjustments. Nonsystematic adjustments are discounts or premiums that relate to a specific company or security—such as key customer dependence or buy/sell agreement transferability restrictions. This discussion explains the common procedures for identifying the factors or conditions that indicate the need for a nonsystematic valuation adjustment in a business/stock valuation performed for estate planning or estate tax purposes. This discussion explains the common procedures for quantifying nonsystematic valuation adjustments. This article includes several simplified illustrative examples. Finally, this article considers the appropriate sequencing of nonsystematic valuation adjustments in a business/stock valuation performed for estate planning or estate tax purposes.

INTRODUCTION

The application of valuation adjustments is common in closely held business/stock valuations performed for estate planning and/or estate tax purposes.

Valuation adjustments can be either discounts (decremental adjustments) or premiums (incremental adjustments). There are “level of value” valuation adjustments that analysts routinely consider in many transactional valuation assignments. These level of value adjustments include: (1) the degree of control or lack of control and (2) the degree of marketability or lack of marketability of the subject business or business interest.

Consideration of level of value adjustments is a common analytical procedure in a business or security valuation. This is because the different valuation approaches and methods typically conclude different levels of value. These types of valuation adjustments are called systematic adjustments. Systematic valuation adjustments typically apply across various industries and across various company types and sizes.

The application of systematic valuation adjustments is influenced by:

1. the legal/economic characteristics of the subject stock (e.g., does the subject stock represent target company operational/ownership control or not?);

2. the selected standard of value (e.g., fair market value, fair value, investment value, etc.); and
3. the selected premise of value (e.g., what premise of value represents the highest and best use of the target business or stock?).

This discussion summarizes these systematic (or level of value) adjustments in order to contrast them with nonsystematic valuation adjustments. This discussion primarily focuses on nonsystematic valuation adjustments. As the name implies, these valuation adjustments do not apply across the board to all business interests of the same level of value. While nonsystematic adjustments should be considered in all estate planning business/security valuations, they are typically applied less often.

CATEGORIES OF NONSYSTEMATIC ADJUSTMENTS

Nonsystematic valuation adjustments typically fall into the following four categories:

1. company-specific adjustments,
2. security-specific adjustments,

3. contract-imposed adjustments, and
4. multitier adjustments.

These four categories will be described in greater detail later in this discussion. As an introduction, these adjustments relate to some factors that are specific to the individual valuation subject (i.e., the target block of stock) that would cause the analyst to apply a valuation discount or premium.

An example of a company-specific adjustment may be key customer dependence. Let's assume that 90 percent of the industrial/commercial company revenue comes from one retail chain customer.

An example of a security-specific adjustment may be supervoting rights. Let's assume the valuation subject is class B common stock that enjoys 100 votes per share, compared to the one vote per share enjoyed by the corporation class A common stock.

An example of a contract-imposed adjustment may be if the stock is subject to a mandatory shareholder agreement. Let's assume that agreement allows the company to call the subject stock at any time at a call price equal to accounting net book value.

An example of a multitier adjustment may be a family limited partnership (FLP) interest that owns the remaining nonmarketable, noncontrolling stock of a closely held corporation. An analyst may apply a multitier adjustment when the corporation owns a substantial amount of liquid assets but neither (1) the subject FLP interest nor (2) the subject closely held stock interest has the right to demand an income distribution or asset liquidation.

These illustrative nonsystematic valuation adjustments do not relate to the level of value of the subject business/stock. And, these illustrative adjustments do not apply across a broad range of valuation subjects. Rather, the application of nonsystematic valuation adjustments is specific to the facts and circumstances of each individual estate planning business valuation subject.

In contrast, while the quantification of nonsystematic adjustments is unique to each individual valuation subject, systematic valuation discounts and premiums are common across a broad range of estate planning business valuation subjects.

This discussion concludes with a summary of caveats regarding the identification and quantification of nonsystematic valuation adjustments in business and stock valuation analyses. However, it is noteworthy to mention a few general caveats regarding valuation adjustments. Financial advisers should consider these general caveats with regard to a business or security valuation prepared for either estate planning or estate tax purposes.

GENERAL CAVEATS REGARDING TRANSACTIONAL VALUATION ADJUSTMENTS

Adjustments Made to Conclude Value

First, both systematic and nonsystematic adjustments, are always made to reach a conclusion of value. Adjustments are not made from a conclusion of value.

Inexperienced valuation analysts are often confused by this important distinction. They believe that the analyst first reaches a conclusion of the correct value for the subject business interest. Then, the analyst applies a discount or premium to the concluded value in order to arrive at a discounted value—or an inflated value.

This misconception is both procedurally and conceptually incorrect. In fact, analysts apply valuation methods to conclude value indications. Each business/security valuation method involves numerous analytical procedures. The various methods provide preliminary indications of value—until all of the requisite procedures are performed. And, one of the requisite procedures in all business valuation methods is to consider (and apply, when appropriate) valuation discounts and premiums.

So, valuation adjustments are applied to a preliminary value indication to arrive at a final value conclusion. Valuation adjustments are not applied to a final value conclusion to arrive at either a discounted or an inflated value conclusion.

Implicit Versus Explicit Adjustments

Second, regarding both systematic and nonsystematic adjustments, the application of adjustments—and the magnitude of adjustments—may vary by valuation approach and method. And, there are two components to this caveat:

1. implicit level of value, systematic adjustments and
2. implicit/explicit quantification of nonsystematic adjustments.

Some valuation approaches and methods typically conclude a certain level of value. The market approach/guideline publicly traded company method concludes a marketable, noncontrolling ownership interest level of value.

Typically, the asset-based approach/asset accumulation method concludes a marketable, controlling ownership interest level of value.

Typically, the income approach/discounted cash flow method can conclude either a controlling or a noncontrolling ownership interest level of value. The concluded level of value depends on the individual valuation variables selected for both (1) the cash flow projection and (2) the present value discount rate.

In each of these instances, the application of a systematic, level of value adjustment will depend on both (1) the level of value typically concluded by the selected method and (2) the individual valuation variables used in the specific analysis of that method.

Therefore, within the same estate planning valuation assignment, systematic adjustments may apply to some valuation methods and not to others. And, depending on the individual variables used within the method, different magnitudes of the same valuation adjustment (e.g., discount for lack of marketability) may apply between the different valuation methods used in the analysis.

Regarding nonsystematic valuation adjustments, sometimes the valuation analyst may make an adjustment implicitly within an individual valuation method analysis. And, sometimes, the valuation analyst may apply an explicit adjustment to the value indication concluded by the individual valuation method.

For example, let's consider a discount for key person dependence. The key person could be the chief executive, chief salesperson, chief design engineer, or any other senior—and strategically important—executive. If the financial adviser uses the income approach/discounted cash flow method, the analyst could quantify a key person dependence discount either implicitly or explicitly.

Implicitly, the valuation analyst could adjust the cash flow projection for the cost to recruit, hire, train, and maintain a hypothetical replacement executive (e.g., a first lieutenant for the key executive).

Explicitly, the valuation analyst could conclude an unaffected preliminary business enterprise value indication—and then subtract either a discrete percentage discount or a discrete dollar discount (for key person dependence) from the preliminary value indication.

As another example, let's consider a discount for lack of voting rights in the valuation of the class B nonvoting common stock (e.g., a class of stock retained by the founding family). Again, the valuation analyst may quantify this valuation adjustment either implicitly or explicitly.

If the valuation analyst uses the market approach/guideline publicly traded company method, the valuation adjustment could be made within the analytical procedures—to conclude an implicitly discounted value indication. Or, the valuation procedures could be performed on unaffected basis, and the preliminary value indication could be explicitly adjusted for the discount.

Implicitly, the valuation analyst could select only guideline company nonvoting stocks from which to extract market-derived valuation pricing multiples. The application of such pricing multiples would conclude a final value indication that is implicitly affected by a lack of voting rights.

Alternatively, the valuation analyst could select voting guideline company stocks from which to extract market-

derived valuation pricing multiples. The application of such pricing multiples would conclude a preliminary value indication that would need to be explicitly adjusted by a percentage discount for lack of voting rights.

Standard of Value Influences

Third, regarding both systematic and nonsystematic adjustments, the application of adjustments is directly affected by the standard (or definition) of value sought in the estate planning business/stock valuation. If the assignment standard of value is fair market value (as is the case with all estate-tax-related business valuations, then most valuation adjustments will typically apply. This is because the marketplace of willing buyers and willing sellers will generally recognize all valuation discounts and premiums.

However, if the assignment standard of value is fair value (as in a statutory dissenting shareholder rights case or a shareholder oppression case), then certain systematic, level of value adjustments may not be considered. In many situations (by statute or by judicial precedent), fair value is synonymous with pro rata business enterprise value (BEV). This pro rata business enterprise analysis concludes a value that is legally “fair” to all parties to the subject litigation.

That is, business enterprise value is the level of value where all shares of stock in the subject company have the same value per share. This is true regardless of whether the shares are owned by a 90 percent controlling stockholder or by a 10 percent noncontrolling stockholder. At the business enterprise level of value, the one stockholder receives no economic reward for squeezing out or oppressing another stockholder.

For example, under this interpretation of fair value, the controlling stockholder is not allowed to pay a “discounted” price of \$10 per share to the noncontrolling stockholder for shares that are worth \$20 per share to that controlling stockholder.

Therefore, in many fair value assignments, certain valuation adjustments are legally not applicable—even if the subject block of stock is a nonmarketable, noncontrolling ownership interest. The valuation principles that support this level of value in a fair value analysis are often called “the economics of fairness.”

Similarly, let's consider the example of an investment value (or owner value) assignment. In such an assignment, the valuation analyst may not apply a nonsystematic discount for a suboptimal product distribution function at the subject company.

If the current corporate owner wants to quantify the value to itself (given its specific corporate investment criteria) of a certain subsidiary, a discount for the lack of a distribution function may not be relevant. Let's assume that the corporate parent is a company like Pfizer—that is,

a pharmaceutical company that is recognized for its world class product distribution function.

Let's assume that the current corporate parent operates the subject company as a manufacturing subsidiary that effectively sells all of its production to a market/distribution subsidiary. For an investment value analysis, the lack of the subject company's distribution system would not represent a value penalty to the current owner. Therefore, the analyst may not apply a nonsystematic lack of distribution function discount in an investment value analysis for a Pfizer-like corporate owner.

As another example, let's assume an acquisition value transactional assignment for a corporate acquirer. Let's assume the subject target company clearly suffers from key person dependence. The target company founder is a key person who will retire at the time that the company is sold.

The potential acquirer is a large, publicly traded corporation that has several tiers of mid-level executives who are qualified to (and waiting for the opportunity to) manage a company the size of the target company.

The acquisition value standard of value indicates what a specific buyer would be willing to pay to a specific seller for the subject business interest. Given (1) the acquisition value standard of value and (2) the fact that the target's key person dependence does not represent a deficiency to the specific corporate acquirer, the valuation analyst may decide not to apply a nonsystematic key person dependence discount in the acquisition value assignment for this particular acquirer.

"Nonsystematic valuation adjustments are . . . specific to the individual facts and circumstances of a particular valuation subject business/business interest."

NONSYSTEMATIC VALUATION ADJUSTMENTS

Something that is nonsystematic is not orderly, regular, or consistent. Nonsystematic valuation adjustments are discounts or premiums that may be considered—but are typically not applied—in all business/security valuations. Rather, they are specific to the individual facts and circumstances of a particular valuation subject business/business interest.

Nonsystematic valuation adjustments generally are grouped into the following four categories:

1. company-specific,
2. security-specific,
3. contract-specific, and
4. multitier.

Each of the four categories is discussed below.

Company-Specific Adjustments

Company-specific valuation adjustments relate to facts and circumstances that are specific to the subject business/security. Common examples of company-specific valuation adjustments include:

1. discount for key person dependence,
2. discount for key customer dependence,
3. discount for key supplier dependence,
4. discount for key product/technology dependence,
5. discount for suboptimal capital structure, and
6. discount for suboptimal cost of capital.

These company-specific valuation factors can be either controllable or noncontrollable. For example, the subject company management may decide to employ a 100 percent equity capital structure because of its aversion to financial risk. However, that is usually a controllable decision.

On the other hand, there may be only one domestic supplier for the company's key medicinal chemicals component. In that case, management's reliance on the key supplier is an example of an uncontrollable decision.

In any event, all of these factors first affect the valuation at the business enterprise level. These factors are not related to the level of value of the subject ownership interest. And, these factors typically do not affect one class of company security differently than another class of company security.

Each of the factors in this category makes the subject company different (from an investment risk and/or expected return perspective) from the typical company in the subject industry or peer group. Accordingly, this category of valuation adjustment is typically made at the company (invested capital or total equity) level.

Security-Specific Adjustments

Security-specific valuation adjustments relate to facts and circumstances that are specific to the subject security interest or block of stock. Common examples of security-specific valuation adjustments include:

1. discount for lack of voting rights,
2. premium for supervoting rights,
3. blockage discount, and
4. discount for lack of preemptive rights.

All of these factors first affect the estate planning valuation at either (1) the class of security level (e.g., a discount for lack of voting rights may be applied to all of the nonvoting common stock) or (2) the specific subject security level (e.g., a blockage discount may be applied to a 25 percent block of stock in an inactively traded public company).

And, each of the factors in this category makes the subject security interest different (from an investment risk and/or expected return perspective) from either (1) the typical security in the subject company or (2) a guideline or benchmark security used for comparative pricing purposes.

In any event, this category of valuation adjustment is typically applied at the subject security level (e.g., at the per share of stock level) and not at the business enterprise level.

Contract-Specific Adjustments

Contract-specific valuation adjustments relate to facts and circumstances that are imposed on the subject security by the influences of a contract, agreement, regulation, or covenant. Common examples of contract-specific valuation adjustments include:

1. stock subject to the buy-sell provisions of a shareholder agreement;
2. restricted publicly traded stock;
3. founder, letter, or other unlisted stock of a listed company; and
4. partnership units subject to a partnership agreement and limited liability company (LLC) units subject to an LLC agreement.

All of these factors affect the valuation of the specific subject ownership interest as the result of an exogenous influence. That exogenous influence is the result of a particular ownership interest being subject to the terms and conditions of some type of contract or agreement. This is often the case with stock owned by a private equity investor.

The contract terms may involve put, call, transfer, or ownership restrictions of a stockholder, LLC, or family limited partnership (FLP) agreement. The contract terms may affect the income distribution or asset liquidation proceeds rights of the subject ownership interest.

In some cases, the contract terms may positively enhance the transferability of the subject ownership interest—such as the put option on ESOP-owned common stock that is a contractual condition of most ESOP trust agreements.

The exogenous influence may be the result of an employment agreement. Such an employment agreement

may prohibit an executive from selling the subject stock (1) while he or she remains an employee or (2) for a specified number of years.

The exogenous influence may be the result of (1) an agreement with security underwriters or (2) a requirement of the Securities Exchange Commission (SEC) or an individual stock exchange. Unlisted shares of stock of a publicly traded company (e.g., founder stock, letter or legend stock, or stock subject to SEC Rule 144) are subject to contractual and/or regulatory transferability restrictions.

Each of the factors in this category makes the subject business ownership interest different (from an investment risk and/or expected return perspective) from either (1) the typical security of the subject company that is not subject to the contractual/regulatory influence or (2) a guideline or benchmark security used for comparative pricing purposes.

In any event, this category of valuation adjustment is typically applied at the subject ownership interest level (e.g., the particular block of stock or other equity units).

Multitier Adjustments

Multitier valuation adjustments relate to facts and circumstances that are specific to the ownership structure of the subject security interest. Common examples of multitier valuation adjustments include:

1. closely held corporation (CHC) stock owned by an FLP,
2. nonconsolidated CHC stock owned by CHC,
3. any multitier ownership where a distribution will trigger the recognition of capital gains, and
4. a fractional or partial property ownership interest inside a CHC or FLP.

Multitier valuation adjustments are sometimes referred to as inside/outside valuation adjustments. In the typical instance, asset A is owned by asset B, which may itself be owned by asset C. Asset C is the valuation subject.

Typically, in order to receive income distributions, the owner of asset C must first liquidate assets A and B. Accordingly, there is a series of security-specific and/or contract-specific adjustments that should be applied in the multitier ownership interest valuation.

In multitier ownership interest valuations, questions arise not only as to the magnitude of the appropriate valuation adjustments. Questions also arise as to the sequencing (and relative magnitude) of the appropriate valuation adjustments.

Typically, the lower level/inside adjustments are applied first, and the higher level/outside adjustments are applied second. That is, adjustments are applied to asset A, and an asset A cash equivalency value is estimated.

Then, adjustments are applied to asset B, and an asset B cash equivalency value is estimated. Finally, adjustments are applied to asset C, and an asset C value is concluded.

SYSTEMATIC VALUATION ADJUSTMENTS

Systematic events affect a broad population and occur with regularity and order. This statement is also true of systematic valuation adjustments. They affect a broad range of valuation assignments. And, the analyst's application of systematic valuation adjustments occurs with great regularity.

In fact, depending on the valuation methods used, virtually all closely held company business/security valuations involve either implicit or explicit systematic valuation adjustments. Accordingly, the valuation analyst should consider the appropriateness of systematic valuation adjustments in virtually all valuations.

Although the category of systematic adjustments is not limited to level of value adjustments, these adjustments are the most common type of systematic adjustments. There are two reasons for this. First, virtually every business/security valuation assignment involves a specified level of value. And, second, alternative valuation methods typically produce value indications at different levels of value.

Therefore, if the analysis involves two or more valuation methods, the valuation analyst will typically have to apply some systematic adjustment in order to conform all of the value indications to the same level of value. All value indications should be stated on the same level of value (typically, the level of value consistent with the valuation assignment) before a meaningful valuation synthesis and conclusion is reached.

The most common systematic valuation adjustments include:

1. discount for lack of marketability (related to any ownership interest less than an overall business enterprise),
2. discount for illiquidity (related to the analysis of the overall closely held business enterprise),
3. discount for lack of ownership/operational control,
4. premium for ownership/operational control, and
5. premium for strategic/synergistic benefits.

The above-listed common systematic adjustments relate to the level of value of the subject ownership interest. Many inexperienced valuation analysts believe that there are only three or four discrete levels of value.

In fact, there is a virtually continuous spectrum of levels of value. And, the spectrum itself typically has two axes: (1) ownership control elements and (2) marketability elements.

There is a broad spectrum of value influences ranging from

1. absolute ownership/operational control with immediate synergistic opportunities to
2. absolute lack of ownership/operational control.

For example, an owner of a 30 percent block of closely held company stock may have significant elements of operational control if there are 70 other unrelated stockholders, each of whom owns only one percent of the closely held company stock. As another example, the owner of a two percent block of closely held company stock can experience the swing vote value influences of control if there are two other unrelated stockholders, each of whom own 49 percent of the closely held company stock.

The owner of 51 percent of a closely held company stock has one level of ownership control. The value of that block of stock would likely deserve some level of control premium. However, in many states, a two-thirds vote is legally required for many corporate "control events" (e.g., a corporate liquidation or a sale of substantially all of the company assets).

Therefore, the owner of a 67 percent block of stock may deserve a greater control premium than the owner of a 51 percent block of stock.

Likewise, the ownership of 80 percent of a company is required to consolidate a subsidiary for both financial accounting and income tax reporting purposes. That's why many acquirers won't pursue a target company unless they are sure of buying at least 80 percent of the stock.

Therefore, the owner of an 80 percent block of stock may deserve a greater control premium than the owner of a 79 percent block of stock.

The owner of a 95 percent block of closely held company stock still has fiduciary obligations to the company's noncontrolling stockholders. The elimination of noncontrolling stockholders eliminates both this fiduciary duty and the possibility of nuisance litigation claims from dissenting stockholders.

Therefore, the owner of a 100 percent block of closely held company stock may deserve a greater control premium than the owner of a 95 percent block of stock.

There is also a continuing spectrum of value influences with regard to marketability elements. This broad spectrum of value influences ranges from:

1. absolute liquidity (equivalent to that enjoyed by actively traded stock listed on a public stock exchange) to
2. virtually absolute illiquidity (imposed by FLP, stockholder, buy/sell agreement, or by an other contract/agreement that restricts transfer, limits potential buyers, and dictates sale price).

The multitier ownership structure of the subject security (e.g., a security owned by an entity that is owned by

another entity) may also have marketability implications that influence value.

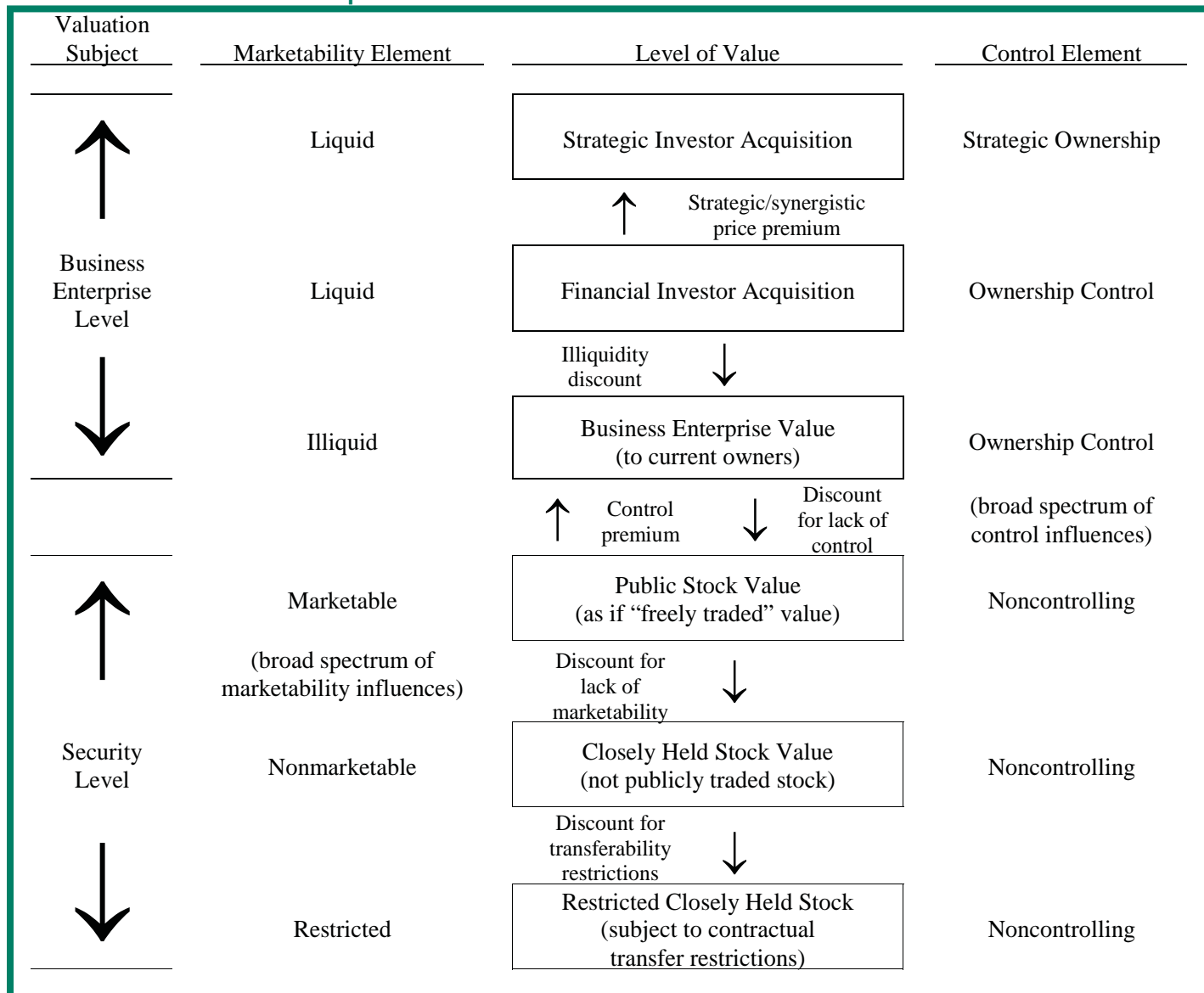
While it may be impossible for financial advisers to conceptualize all of the discrete steps along the control/marketability continuum, these two elements really represent a continuous spectrum of combined valuation adjustment possibilities.

However, for visualization and illustrative purposes only, Figure 1 represents several of the common levels of value with regard to business/security valuation. Where applicable, Figure 1 also presents simplified indications of the valuation discount/premium relationships among the common levels of value.

Nonsystematic valuation discounts and premiums may be quantified as either (1) a percentage adjustment or (2) a dollar amount adjustment. When both percentage and dollar amount adjustments are appropriate, the financial adviser should carefully consider the appropriate sequence for applying the adjustments.

However, systematic valuation discounts and premiums (particularly level of value adjustments) are typically quantified as percentage adjustments. Therefore, if both control influence and marketability influence discounts/premiums are applied as percentage adjustments, then the mathematical sequencing of the application of systematic adjustments is often irrelevant.

Figure 1
Estate Planning and Estate Tax Valuations
Business/Security Valuation Adjustments
Simplified Illustration of Common Levels of Value



That is, as long as they are all expressed on a percentage discount or premiums basis, the systematic valuation adjustments usually can be applied in any order.

WHY VALUATION ADJUSTMENTS ARE INTEGRAL TO THE VALUATION PROCESS

Experienced financial advisers understand that the concept of a valuation adjustment is meaningless without a clear answer to the question: adjustment to what? The valuation analyst first has to understand the baseline or benchmark against which any valuation discount or premium is contemplated. In other words, the application of any valuation discount or premium is fundamentally inappropriate unless the benchmark (against which the adjustment is compared) is clearly defined.

For example, it may be inappropriate to apply a discount for lack of marketability to a value indication that is already stated on a nonmarketable basis. Likewise, it may be inappropriate to apply an ownership control premium to a value indication that is already stated on a controlling ownership interest basis.

The first question for the valuation analyst to ask with regard to a valuation adjustment is: What do I have? This question relates to what systematic and nonsystematic elements exist in:

1. the valuation approaches and methods selected,
2. the valuation variables used,
3. the guideline or other transactional data extracted, and
4. the valuation indications derived.

These elements (which either are present or are absent) represent the baseline or benchmark of the valuation analysis.

The second question for the valuation analyst to ask with regard to a valuation adjustment is: What do I want? This question relates to what systematic and nonsystematic elements exist in (1) the subject company and/or (2) the subject security/ownership interest.

In particular, the valuation analyst is looking for operational, financial, contractual, and regulatory features of the subject company/security that are different from those of the benchmark analysis. These selected features should make the subject company/security different from the benchmark analysis from an investment risk/expected return perspective.

It should be obvious why the valuation analyst should thoroughly understand the benchmark analysis first. At this point in the valuation, the benchmark analysis is what the financial adviser has. Ideally, the benchmark analysis should perfectly match the subject company/security from an investment risk/expected return perspective.

This is because an analysis of the subject company/security is what the valuation analyst wants. If the elements in the benchmark analysis match up perfectly with the elements in the subject company/security, then no valuation adjustment is needed. Of course, that is rarely the case.

Therefore, the third question for the valuation analyst to ask with regard to a valuation adjustment is: How is the subject company/security different from the benchmark analysis? When answering this question, the analyst identifies all of the systematic and nonsystematic elements in the subject that are not in the benchmark analysis—and vice versa.

Finally, the fourth question for the valuation analyst to ask with regard to a valuation adjustment is: How do I get to what I want from what I have? In other words, what transactional adjustments are needed to make the value indications/ conclusions of the benchmark analysis more applicable to the valuation subject?

Alternatively, what valuation adjustments are needed to minimize the systematic and nonsystematic element differences between the benchmark analysis and the valuation subject?

It is noteworthy that this fourth question helps the valuation analyst identify valuation adjustments that make the investment risk/expected return features of the benchmark analysis look more like the valuation subject. It is not the objective of valuation adjustments to make the investment risk/expected return features of the subject company/security look more like the benchmark analysis.

In summary, valuation adjustments are only applicable to make the benchmark or baseline analysis look more like the subject company/security from an investment risk/expected return perspective. Therefore, it is important that the valuation analyst fully understand the systematic and nonsystematic elements of the benchmark analysis before any valuation adjustments are considered.

In addition, the selection of the valuation adjustments is influenced by:

1. the specific valuation approaches, methods, and procedures performed and
2. the purpose and objectives of the analysis, including the standard of value and the premise of value appropriate of the individual assignment.

ILLUSTRATIVE LISTING OF VALUATION ADJUSTMENTS

Table 1 presents a noncomprehensive listing of common valuation discounts and premiums. Table 1 does not distinguish between systematic (or level of value) adjustments and nonsystematic adjustments.

Table 1
Estate Planning and Estate Tax Valuations
Business/Security Valuation Adjustments
Illustrative List of Common Valuation Discounts and Premiums

Valuation Discounts Related to:	Valuation Premiums Related to:
Assignee ownership interest	Ownership/operational control
Blockage (size) of public stock	Put options
Built-in capital gains taxes	Strategic/synergistic benefits
Call options	Superliquidation preference
Founder/letter/legend stock	Supervoting rights
Illiquidity (at business enterprise level)	
Key customer dependence	
Key person dependence	
Key supplier dependence	
Key technology dependence	
Lack of dividend rights	
Lack of marketability (at security level)	
Lack of ownership/operational control	
Lack of preemptive rights	
Lack of voting rights	
Multitier ownership structure	
Partial/fractional ownership interest	
Right of first refusal	
SEC Rule 144	
Suboptimal capital structure	
Suboptimal cost of capital	
Transferability restrictions (contractual)	
Unlisted stock of public company	

While Table 1 is not intended to be comprehensive, it may provide a convenient valuation adjustment checklist or reminder list for the analyst performing a business or security valuation.

METHODS TO QUANTIFY VALUATION ADJUSTMENTS

There are numerous analytical procedures that are used to quantify individual valuation adjustments. When considered conceptually, all of these individual procedures are grouped into four categories of methods:

1. comparative empirical data regarding the valuation subject,
2. comparative income data regarding the valuation subject,
3. published empirical data regarding valuation guidelines/benchmarks, and
4. reliance on judicial/administrative guidance.

Each of the four categories of methods is described below.

The first two above-listed methods use data extracted directly from the subject company/security. If such data are available, then these methods provide valuation adjustment indications that are specifically derived from the valuation subject.

In the first method, the analyst compares the valuation subject to a benchmark or baseline that does not have the discount/premium value influence. Based on this comparison, the analyst extracts pricing metric data that are used to quantify the specific valuation adjustment.

In the second method, the analyst compares some measure of the valuation subject income to the same income measure, adjusted to exclude the effect of the valuation discount/premium. The capitalization of this income differential provides an indication of the appropriate amount of the valuation adjustment.

Using the comparative empirical data method, the analyst typically looks for comparative sales involving the subject security, where (1) one sale doesn't have the

particular discount/premium feature and (2) the otherwise comparable sale does have the particular discount/premium feature.

For example, let's assume that there were historical sale transactions involving two classes of the company stock (one class with voting rights and one class without voting rights). The analyst could examine these transactions and extract a discount for lack of voting rights.

Likewise, let's assume that there were historical sale transactions involving (1) stock subject to a right of first refusal and (2) otherwise comparable stock not subject to a right of first refusal.

Again, the analyst could examine these transactions and extract a discount related to a contractual agreement right of first refusal.

Using the comparative income data method, the analyst typically identifies revenue, expense, or investment differences that are attributable to the particular discount/premium feature. The analyst attempts to quantify how the subject revenue, expenses, or investment would change if the particular discount/premium feature changes.

The analyst then capitalizes the expected income change over the remaining useful life (RUL) of the income change. The present value of the projected income difference provides an estimate of the amount of the valuation discount/premium.

For example, let's assume that Fred Founder is the controlling stockholder at Alpha Corporation, a closely held and family-owned corporation. As controlling stockholder, Fred Founder pays himself a salary that is \$1 million per year greater than a reasonable salary level for a comparable executive at a comparable company. The valuation analyst is attempting to quantify the ownership control premium associated with Founder's stock ownership interest.

The valuation analyst could (1) isolate the economic benefit associated with the Founder ownership control (i.e., his excess compensation) and (2) capitalize that benefit at an appropriate capitalization rate. The capitalized excess compensation is one indication of the amount of the Founder ownership control premium.

All of the procedures related to the empirical data and the empirical income methods ultimately involve three types of analyses:

1. estimate of the income shortfall related to the valuation discount; estimate of the income excess related to the valuation premium,
2. estimate of the cost to cure the deficiency feature, and
3. paired sales analysis of (a) transactions with the subject discount/premium feature and (b) transactions without the subject discount/premium feature.

The empirical data and empirical income methods rely on income, cost, or sales data extracted from the subject company in order to quantify the systematic or nonsystematic valuation adjustment. The published empirical data method is the most commonly used method to quantify valuation discounts and premiums. Arguably, it is also the most commonly misused method.

Many valuation analysts rely on published studies of empirical data to derive level of value adjustments, such as a discount for lack of marketability or a premium for ownership control. There are also numerous published studies with regard to nonsystematic valuation adjustments as well, such as a discount for lack of voting rights.

Most published empirical studies rely on the paired sales analysis procedure. These studies analyze:

1. one set of sale transactions that are not affected by the subject feature and
2. one set of sale transactions that are affected by the subject feature.

The percentage difference in transaction prices (or the percentage difference in transaction pricing multiples) provides an indication of the amount of the individual valuation discount or premium.

The difference in this third method (compared to the first two methods) is that both sides of the paired sales analysis comparison relate to guideline company/security transactions. In other words, none of the data analyzed in these published studies actually comes from the subject company/security.

This factor should not invalidate the use of this method however. The concern regarding the use of this valuation adjustment quantification method is not the data source. The concern is how the valuation analyst relies on the published study results to select subject-specific valuation adjustments.

"The concern regarding the use of this valuation adjustment quantification method . . . is how the valuation analyst relies on the published study results to select subject-specific valuation adjustments."

Often, analysts rely on the more popular published empirical studies:

1. without understanding the procedural mechanics of the published study,
2. without understanding the type (e.g., industry, size, etc.) of transactions analyzed in the published study, and
3. without considering the time period of the published study (compared to the subject valuation date).

In addition, valuation analysts select the mean or median conclusion from the published study as the appropriate valuation discount or premium in every business/security valuation. When this happens, the resulting analysis has not reflected the range of results indicated by published studies—such as the interquartile conclusions, the standard deviations, and the high/low observations.

And, the resulting analysis has not considered (qualitatively or quantitatively) exactly what valuation adjustment would be appropriate to the unique factors of the specific subject company/security—given the range of data reported in the published empirical study.

The fourth method for quantifying valuation adjustments relies on published judicial precedent and administrative rulings (e.g., Internal Revenue Service ("Service") audit settlement agreements) for guidance. While this method is sometimes used by inexperienced analysts, it is not recommended by experienced analysts.

This method does provide the analyst with very useful information as to the reasonable range of valuation discounts and premiums that courts and regulators have found acceptable. However, these data do not provide a particularly useful source of information from which to select a specific valuation adjustment related to a specific business valuation.

Judicial precedent, Service letter rulings and settlement agreements, and other administrative rulings are always fact-specific. By definition, they only apply to the specific facts and circumstances of the matter and/or taxpayer to which they apply. They are not intended to provide general professional guidance with regard to the appropriate level of valuation discounts and premiums.

Published judicial decisions (and other rulings) are only applicable to the extent that the subject company/security facts and circumstances are identical to the published decision facts and circumstances. And, that is hardly ever the case.

VALUATION ANALYST CAVEATS

Table 2 on the following page presents a nonexhaustive listing of 10 caveats that valuation analysts should consider with regard to the identification and quantification of valuation discounts and premiums for estate planning/estate tax valuations. These "top 10" caveats apply to all four methods for quantifying valuation adjustments.

SUMMARY AND CONCLUSION

This discussion focused on the identification and quantification of non-systematic and multitier valuation adjustments. This discussion also touched on the identification and quantification of systematic (e.g., level of value) valuation adjustments.

This discussion considered both (1) when and (2) why valuation adjustments are applicable in the estate planning business/stock valuation process. This discussion presented an illustrative (but nonexhaustive) list of common business/security valuation discounts and premiums.

In particular, this discussion presented (1) the four common methods for quantifying valuation adjustments and (2) the three common procedures for quantifying valuation adjustments. Comparative conceptual/practical strengths and weaknesses of the various valuation adjustment methods were discussed.

And, this discussion presented a nonexhaustive list of "top 10" caveats that analysts should consider when selecting specific business/security valuation discounts and premiums for estate planning/estate tax valuation purposes.

"Judicial precedent, Service letter rulings and settlement agreements, and other administrative rulings . . . are not intended to provide general professional guidance with regard to the appropriate level of valuation discounts and premiums."

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Table 2
Estate Planning and Estate Tax Valuations
Business/Business Interest Valuation Adjustments
"Top 10" List of Caveats Regarding Valuation Discounts and Premiums

1. Valuation analysts should thoroughly understand the valuation analysis baseline or benchmark before applying any valuation adjustments.
2. Valuation analysts should thoroughly understand the economic influences of the specific systematic or nonsystematic feature considered; does it actually affect the investment risk and/or expected return of the subject company/practice?
3. Valuation analysts should be careful not to “double count” valuation adjustments. For example, a valuation discount for the built-in gains tax may be a component of an overall discount for lack of marketability—and not a separate, discrete valuation adjustment.
4. When valuation analysts use alternative procedures to quantify valuation adjustments (e.g., income short-fall/excess, cost to cure, paired sales analysis), the lowest valuation adjustment indication is often the most appropriate valuation adjustment conclusion.
5. Valuation analysts should not solely rely on published judicial precedent as the basis of selecting specific valuation adjustments, unless the facts and circumstances in the subject valuation are identical to those in the published decision.
6. Valuation analysts should be aware that not all valuation methods/indications may be subject to the same valuation adjustment—or to the same magnitude (either dollar amount or percentage) of valuation adjustment.
7. Valuation analysts should recognize that the application of valuation adjustments is influenced by the purpose and objective of the analysis (e.g., the assignment standard of value, premise of value, etc.) as well as by the specific features of the subject company/practice.
8. Valuation analysts should be sufficiently familiar with the content and intent of published empirical valuation adjustment studies before relying on such published studies as the basis of selecting a specific valuation discount or premium.
9. Valuation analysts should carefully consider the time period covered in any published empirical valuation adjustment study before relying on that published study for use as of a specific valuation date.
10. Valuation analysts should carefully consider the dispersion of the results reported in published empirical valuation adjustment studies. Valuation analysts should avoid the naive reliance on the mean or median results of such published studies without considering whether such conclusions are applicable to the specific facts and circumstances of the subject valuation.