

Critique of Implied Private Company Pricing Line¹

The authors used 500 transactions from the *Pratt's Stats* and *BIZCOMPS* databases (100% controlling interest transactions) in developing their reported results.² The underlying transactions are available from the IPCPL website. An appraiser utilizing the IPCPL should be familiar with the strengths and weaknesses of the databases from which the underlying transactions are sourced.³

The following are some points that the analyst should be aware of concerning the 500 transactions that make up the underlying IPCPL:

The dataset is comprised of 243 *Pratt's Stats* transactions. Of these transactions, 72 are classified as stock sales and 171 are classified as asset sales. As outlined by Fannon and Walker:

The *Pratt's Stats* transaction database contains both asset and stock deals. While both can be used in developing value indications, they should be used separately because different assets and liabilities of the company being valued must be added or subtracted once the multiple has been applied.⁴

The dataset is comprised of 257 *BIZCOMPS* transactions.

A main difference between the two databases involves the treatment of inventory. Inventory is assumed to be included in an asset transaction under the *Pratt's Stats* database; although the frequently asked questions of the database directs the analysts to look closely at the underlying transaction. Inventory is excluded in the transaction price in the *BIZCOMPS* database. In developing the IPCPL database, the *BIZCOMPS* market value was adjusted to include inventory based on the average percentage of inventory to sales of each data sets' selected transactions.

The inventory-to-sales ratio for the 500 selected transactions in the IPCPL database ranges from 0% to 69.36%. Approximately 64% of the 500 transactions had an inventory-to-sales ratio of 5% or less; approximately 90% of the 500 transactions had an inventory-to-sales ratio of 15% or less.

¹ This section is drawn from Kim Linebarger, "Cost of Capital for Closely Held Businesses", Chapter 27, in Pratt and Grabowski. Used with permission.

² Both databases are available from Business Valuation Resources at bvresources.com.

³ The uses and abuses of these databases and other transactional databases have been laid out in great detail in Nancy Fannon and Heidi Walker, *Comprehensive Guide to the Use and Application of the Transaction Databases*, 2009 Edition (Portland OR: Business Valuation Resources, October 30, 2009).

⁴ *Ibid*, p. 2–4.

The sale date of the selected transactions spans from December 4, 1997 through September 30, 2012, a 15-year timeframe. The developers indicate that they have applied an adjustment for the current ERP on the market and the expected rate of inflation and growth.⁵

Note that *BIZCOMPS* annually removes multiples that are older than 11 years.⁶

The changes, or lack thereof, in pricing multiples over time has been the subject of research. One study concluded that transaction data several years old can validly be employed.⁷ Another study concluded that certain industries have been fairly consistent over time while other industries exhibit a great deal of variability.⁸

The analyst should be aware of the timeframe adjustment and that the adjustment used by the developers of the IPCPL does not take into account the degree of changes experienced within specific industries overtime.

In analyzing the make-up of the transactions used, it was found that over 50% of the transactions are within the \$4 million to \$5.9 million revenue range. One should be aware of the types of companies included in the 500 transactions.

The most common industry in the 500 transactions is automotive dealers and gasoline service stations (74) of which 48 were, gasoline stations. Using data from the Bureau of Labor Statistics (BLS) 2007 County Business Patterns and 2007 Economic Census⁹ for comparison, one author found there are under and over weighted industries within the IPCPL when compared to the market universe of companies within the U.S.

Even within a broad industry there can be large divergences of risk. The analyst should be aware of the differences between the selected universe of the 500 transactions that comprise the IPCPL and the universe of comparable U.S. companies.

Owners' compensation in each of the transactions has been adjusted. The calculation of the market compensation adjustment is available from the IPCPL website. The underlying data is from PayScale.com for various major U.S. cities. This data is then used to derive an exponent that is applied to each selected transaction based on that specific company's revenue size and an inflation affect offset adjustment.

Adjustment to owners' compensation is one of the most common and also most debated adjustments in the valuation of a closely held business.¹⁰ The practitioner needs to be aware of the imbedded owners' compensation adjustment within the development of the IPCPL.

⁵ Dohmeyer and Butler, p. 46.

⁶ Jack R. Sanders, *BIZCOMPS User Guide* (Business Valuation Resources), p. 7.

⁷ Raymond Miles, "Business Values in the Real World: Evidence from the IBA Market Database," ASA Business Valuation Conference (Houston: October 23, 1993), p. 12.

⁸ Gary R. Trugman, *Understanding Business Valuation* (AICPA, 2008), p. 250; Fannon and Walker, op. Cit., pp. 9–1; Larry J. Kasper, "The Effect if Willing Sellers on Valuations of Privately Held Businesses," *Valuation Strategies* (May/June 2013), pp. 4–19, 42.

⁹ Bureau of Labor Statistics, 2007 County Business Patterns and 2007 Economic Census, <http://www.census.gov>. BLS data is of the number of firms that comprised various 3-digit North American Industry Classification System (NAICS) and size (revenues) between \$2.5 million and \$9.9 million compared to the total number of firms with revenues between \$2.5 million and \$9.9 million. The data includes establishments with employees.

¹⁰ For more information concerning officers' and owners' compensation adjustments, see Trugman, pp. 186–187.

But observed transaction prices reported in *Pratt's Stats* and *BIZCOMPS* databases used for the first data point are for completed transactions. That is, the marketing of the closely held business has been successful in matching a willing buyer with a willing seller. With regards to a closely held business, there is no guarantee that the business will be successful sold at a price represented by the reported transaction prices. The smaller the closely held business, the more difficult it is to locate a willing buyer. Overall data suggests that only 20% to 30% of small businesses that the buyer takes to market to sell are sold.¹¹

Therefore, data used in that first datapoint in developing the IPCPL is likely biased it is based on the selling prices of successful sales and not weighted for the number of small businesses offered for sale that never sell. The cost of capital for closely held businesses put up for sale but never sold is likely greater (i.e., the price needed to be less than the price offered) than for the one's that sold. Besides data issues, the analyst using the IPCPL should be aware that their cost of capital results already imbed premium for lack of liquidity inherent in closely held businesses, so caution should be used in applying any discount for lack of liquidity as to not double count; company-specific risk factors of very small companies not captured by size premiums drawn from public company data; and company-specific risk factors applicable to the pool of undiversified investors who represent the pool of likely willing buyers for the businesses comprising the dataset.

Appraisers using the *IPCPL Tool/Calculator* should understand that there is an arbitrary 5% premium for company-specific risk above the IPCPL included in its calculations.¹²

The data relied upon is not sourced with the same kind of rigor that is emblematic public company data and to that extent the method is limited.

The authors of the IPCPL claim that their results represent an unlevered cost of equity. But prices paid for acquisitions as reflected in the *Pratt's Stats* and *BIZCOMPS* databases reflect leverage used by buyers in making the purchases. While multiples are expressed as a return on operating income, prices paid are dependent upon amount of financing available and used by buyers. The average multiple reflects typical financing used by buyers.

¹¹ See, e.g., "What are the Odds That You Will Sell Your Business," <https://exitoasis.com/what-are-the-odds-that-you-sell-your-small-business/>; and "Study Shows Why Many Business Owners Can't Sell When They Want To," <https://www.forbes.com/sites/sageworks/2017/02/05/these-8-stats-show-why-many-business-owners-cant-sell-when-they-want-to>. Also see the discussion in Chapter 19.

¹² "The Implied Private Company Pricing Line/The Implied Private Company Pricing Model: A Business Valuation Update Special Feature," (Business Valuation Resources, 2014). Available at <http://www.bvresources.com/pdfs/IPCPLDownload.pdf>.