

The Value of Fair Market Value

Private firms can be valued under multiple standards of value, the most notable standard being *fair market value* (FMV). The FMV standard has several important implications for establishing the value of a private firm. These include identifying the circumstances under which a business entity is being valued, the quality of the information that various valuation models require, and a logical framework for establishing the basis of value. This discussion is important because the models and metrics in this book are designed to establish a private firm's FMV. Therefore, understanding the meaning of FMV and all that it implies is crucial to understanding the steps necessary to determine a private firm's FMV. The IRS applies the FMV standard to all gift, estate, and income tax matters. IRS Revenue Ruling 59-60 in part states:

FMV is the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing to trade and to be well informed about the property and concerning the market for such property.¹

Other valuation standards include *liquidation value* and *investment value*.² The Financial Accounting Standards Board (FASB) uses the term *fair value* when referring to financial reporting standards that require booking assets and liabilities at FMV. Since FMV is associated with a large body of case law developed in the context of tax regulation that may not be relevant for financial reporting purposes, the FASB concluded that the fair value naming convention was appropriate under the circumstances. However, the name difference does not imply that there is any substantive difference in the

concepts. Other standards of value differ from FMV in that they do not incorporate all of the criteria that an FMV standard requires. Therefore, FMV can be thought of as a baseline value standard with other value standards being distinguished by lack of one or more of the attributes that define the FMV standard.

FAIR MARKET VALUE: THE MEANING FOR THE VALUE OF PRIVATE FIRMS

Three features embody FMV:

1. The notion of a hypothetical transaction that leads to the establishment of an exchange value.
2. Willing buyer and willing seller.
3. Reasonably informed parties to a transaction.

Hypothetical Transaction

When determining the value of a public firm, one can always defer to the financial markets for guidance. If we consider a firm that is all equity financed, has a recently established share price of \$10, and 1 million shares outstanding, then the firm's market capitalization, and the firm's value, is \$10 million. Therefore, to determine the value of an equity interest in a public firm, one does not need to assume a hypothetical transaction; one only needs to view the most current share price.

Since a private firm by definition does not have any economic interest traded in a market, the value must be established under an assumption of a hypothetical transaction. The outcome of a hypothetical transaction is an exchange price that reflects the price that would result in an exchange between willing and informed parties, and in this sense the exchange would be fair. Therefore the hypothetical transaction is assumed to mimic the process that would occur in a market between willing informed buyers and willing informed sellers. This does not mean that a market price would be established, but rather that the process of arriving at exchange value or price would be the same as would occur if the participants were operating in a market.

The notion of a fair exchange flows directly from the concept of parties to the transaction being fully informed. If both parties have the same information and act on it, then the resulting price must be fair. Markets are generally believed to provide exchange prices that are fair because it is assumed that all parties and/or their agents have equivalent information about the risks and opportunities that are expected to impact the performance of the firm whose economic interest is being transacted. Thus, transaction prices

would not be fair if groups of participants were disadvantaged in the sense that their access to information is limited or the quality of what they have access to is substantively deficient. Transaction prices are generally believed to be consistent with FMV when transactions take place in markets governed by regulations designed to maximize accurate and timely disclosure of critical financial data and other performance information. Therefore, in markets characterized by asymmetric information, transaction prices will not meet the FMV standard.

Willing Buyer and Willing Seller

This characteristic means that potential buyers and sellers are not forced to transact. Each party can withdraw and, in most cases, can do so without a penalty. In contrast, a liquidation value standard requires that the selling party transact and accept the best price. In this case, sellers cannot withdraw and therefore have no recourse as they would under the FMV standard. Moreover, *willing* also implies that market participants have the means to be parties to an exchange. Calculating the FMV of a private firm assumes that hypothetical buyers have the financial wherewithal and sellers have the legal right to sell the interests in question.

Reasonably Informed

This attribute means that buyers and sellers are cognizant of an entity's true cash flow and also have expectations of future performance consistent with those held by knowledgeable market participants. Let us consider the cash flow issue first. Assume that Company X reported no profit in each of the past five years. Would having this knowledge meet the reasonably informed criteria? The answer is no if, after disentangling the firm's financial statements, one established that the firm indeed made a profit in each of the past five years, and a fairly large one at that. How could this happen? If analysis of the firm's financial statements showed that lack of reported profit was the result of the owner receiving a salary in excess of what an outside executive would normally receive for doing the same job, or payments to family member employees far in excess of what unrelated people would earn for the same work, or the existence of other expenses like club fees that were purely discretionary, then one might reasonably conclude that adjusting reported expenses for these excesses would result in the firm earning a profit. Although the financial statements were accurate in this example, being reasonably informed means more than being informed about the accuracy of the financial statements. *Reasonably informed*, in the context of FMV, means that market participants are knowledgeable about the true financial condition of the firm.

Being reasonably informed also means that parties to a transaction have performance expectations that are fully consistent with those held by knowledgeable market participants. Since the hypothetical transaction that informed parties engage in is intended to mimic the information processing that ordinarily takes place in a market environment, it follows that informed investors in a private transaction would also require, at a minimum, the quantity and quality of information that would normally be available to them if they were engaging in a market-based transaction.

Finally, the reasonably informed criterion also means that participants and/or their agents can accurately process disclosed information and rationally act on it. If this were not the case, then accurate disclosures about the current and expected future performance of the transacted entity would have no practical meaning. The assumption of rational participants in a transaction that underlies FMV can best be appreciated by considering the logic often presented for the difference in value between a controlling and a minority economic interest.

FMV AND THE VALUES OF CONTROLLING AND MINORITY INTERESTS

A *minority owner* is one who exchanges cash for the right to receive future cash flow, but who has no influence over how the assets of the firm that produce the cash flow are managed and/or financed. A *control owner* has the right to alter how the assets are used and financed, and also has control over the size and timing of any cash distributions. Because minority owners have no control over cash distributions, it is often believed that minority ownership in a private corporation has little or no value.

To understand the full implications of this last point, consider the following hypothetical transaction: A firm's control owner desires to sell a minority interest in the firm. The minority investor exchanges cash in return for a minority interest because he believes that he will receive regular distributions from the firm. Once the transaction is completed, the control owner raises his compensation to the point where the firm can no longer make any distributions. Knowing that a control owner can do this, the question is, why would anybody purchase a minority interest in a private firm for anything more than a trivial sum? Because of this possibility, it is often concluded that a minority interest is worth much less than a controlling interest in a private firm.

The problem with this logic is that it is inconsistent with the FMV standard. Indeed, under the preceding scenario, a transaction would never take place. The reason is that FMV assumes a rational buyer. That is, under what conditions would a rational informed investor purchase a minority interest in

a private firm? Surely no rational investor would purchase any minority shares under the preceding conditions. Since no transaction would take place, minority discounts cannot be based on this logic. What logic is implied under an FMV standard that offers guidance about the size of a minority discount in a hypothetical transaction? Although, FMV does not stipulate the conditions under which a minority interest is transacted, it does imply that a rational and informed buyer would never purchase a minority interest in a private firm unless there were enforceable oversight provisions and associated financial penalties for noncompliance by the control owner. Oversight provisions might include a board seat and the ability to audit the books on a regular basis. While oversight is critical to the minority owner being kept reasonably informed about the operations of the firm, the minority owner still has no control over who receives cash distributions, how much they receive, and the timing of when the cash distributions are made. Nevertheless, there are a number of ways rational minority owners could protect themselves from potential abuses by a control owner. Such protections will be a function of the fact pattern that is unique to each valuation circumstance. The point here is not to articulate what these protections might be, but rather to suggest that a rational acquirer of a minority interest would demand such protections before purchasing a minority interest. This discussion suggests that determining the FMV of a minority interest under the assumption of a hypothetical transaction implies that reasonable protections are in place so the control owner cannot siphon off cash at the expense of the minority owner.

FMV AND STRATEGIC VALUE

FMV requires that participants are reasonably informed about the risks and opportunities of the property in question and are also knowledgeable about the factors that shape the market in which the entity is expected to transact. This implies that the business is being valued on a going-concern basis. For example, assume that a textile firm recently sold for \$1,000. The acquirer plans to use the assets of the firm to produce steel, and is willing to pay a premium over its value as a textile firm to ensure that his offer is accepted. Is \$1,000 the textile firm's FMV? The answer is no. The reason is that the price does not reflect the value of the firm as a textile producer but rather as a steel company. Thus, when FMV is the standard of value in a hypothetical transaction, the standard assumes that the entity being transacted will continue to operate as it had before the transaction. This follows from the definition of FMV, which states that the buyer and seller are well informed about the "property and the market for such property."³ In the example, the market for this property is the market for the textile firm, and hence its FMV is based on this.

Strategic or investment value emerges when an acquirer desires to use the assets of the acquired firm in a specific way and this use gives rise to cash flows in addition to those that can be expected from the firm being operated in its going-concern state. To see the difference between investment value and FMV, consider the following example. A local insurance agent would like to sell her agency. An informed potential buyer who desires to run the agency much like the seller is willing to pay \$1,000 for the agency. The seller believes this price is consistent with the firm's FMV. A nationally recognized financial services firm has decided to purchase local agencies all over the country as part of a roll-up strategy designed to reduce the costs of managing local agencies as well as to sell additional insurance products to the client bases of purchased agencies. The nationally recognized financial services firm is a strategic buyer. This buyer is always willing to pay more than a buyer who desires to run the business like the seller. The reason a strategic buyer will pay a premium over FMV is that the buyer expects the combined businesses to generate more cash flow than they could produce as two stand-alone entities. The price established by the strategic buyer is not the firm's FMV because the exchange value is not based on the business as it is currently configured. FMV does include a control premium; however, it is only partially related to the premium established via a strategic acquisition. In a strategic purchase the control premium is made up of two components—the value of pure control and the synergy value that emerges from the combination that is captured by the seller in the competitive bidding process. In the preceding example, the strategic buyer is willing to pay a premium over the value of the agencies cash flows for the right to manage and finance the assets to ensure that the expected cash flows from the going concern accrue to the owner. This is the value of pure control, and it is based on the risks and opportunities of the entity as a going concern. The second part of the premium emerges because of the synergy value created by the combination. This portion is not part of the acquired firm's FMV. Therefore, investment value is effectively equal to the FMV of the acquired firm plus the captured synergy value.

This last result bears directly on the calculation of a firm's minority equity FMV. Without reviewing the arithmetic of translating a reported premium for control to the implied discount for a minority interest, we simply note that a 50 percent control premium translates to a 33 percent minority discount.⁴ In practice, a valuation analyst will typically arrive at a firm's control equity FMV and then reduce it by the implied minority discount to arrive at the firm's minority equity FMV. To see this, let us assume the valuation analyst arrived at a control value of \$150 for an all-equity firm. From a number of control premium studies, the analyst calculated a median control premium of 50 percent, then calculated the implied minority discount of

33 percent. This means that the minority equity FMV is \$100, which amounts to a 33 percent discount to its control FMV of \$150. However, the discount calculated was based on a control premium that is likely made up of both a pure control premium and a synergy option. If the reported 50 percent control premium is divided evenly between pure control and the synergy option, the minority discount would be 20 percent and the minority value of equity for FMV purposes would be \$120.⁵ Thus, using raw control premium data to calculate a minority discount will overstate the discount and result in a minority equity value that is too low. In turn, the overstatement of diminution in value will be greater the larger the synergy option is relative to the total control value. Chapter 7 addresses valuing control and sets out a method for estimating the value of pure control.

SUMMARY

In most instances, the standard of value used to value private firms is FMV. Unlike public firms, whose prices are established in organized markets, the value of a private firm's equity must be estimated under the assumption of a hypothetical transaction. The notion of a hypothetical transaction under which a firm's FMV is established requires that one articulate the implications of the standard to establishing value. FMV requires the valuation analyst to assume that the parties to a transaction are reasonably informed about the relevant facts. This criterion means that the valuation analyst must use all the information that a reasonably informed investor would use to arrive at FMV. In other words, FMV is established for a private firm when the process used to establish value effectively mimics what would occur if the transaction took place in a properly regulated public market environment. Market prices are assumed to be fair because parties to a market transaction have equivalent information, so neither buyer nor seller is disadvantaged.

This chapter also addressed the implication of FMV for valuing minority interest; namely, the valuation of a minority interest assumes that the minority owner has some protections in place that limit potential abuse by the control owner. Valuing control is taken up in Chapter 7.