

Q&A

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A free Q & A periodical to promote education, build consensus and answer your questions in the financial valuation and litigation services industry.

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CAPITAL STRUCTURE WEIGHTS

Question 1: I have heard that when developing a WACC for a minority interest, it is often appropriate to use the existing capital structure since the minority investor cannot change the capital weight. I assume, however, that if you normalize the benefit stream to a control stream and take a minority discount, you would use the industry average or optimum capital structure rather than the existing capital structure. Do you feel my assumption is correct?

Answer 1: I think it is easier to leave the capital structure at minority. It can sometimes be difficult to use an optimal capital structure for a small company. Also, the only place to get capital structure info that is market-value based is the public markets, and many private companies may be unable to get the same level and type of debt. One way to look at it is to figure out how much a banker would lend on a secured basis. I do not believe that you have to value a company first on a control basis to get to a minority

basis. Lack of control discounts for operating companies are often difficult to support, given the problems with some of the data.

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BETA

Question 2: I calculate beta coefficients for cost of capital using historical stock prices from *YAHOO! Finance*. I make a mean-reversion adjustment to the calculated beta, as stated in the *SBB! Valuation Yearbook*. Recently, I began incorporating R-squared (coefficient of determination) into my analysis to better understand how meaningful the comparable public company beta is. What should be the cut-off point where a beta is no longer meaningful: an R² of 5 percent, 10 percent, 20 percent or something higher?

Answer 2: Is the beta significantly different from 1.0? What is the standard error? How large is the sample size (>25 to get meaningful results)? An R² of 5 percent or 10 percent means the correlation barely exists. Even 20 percent is not very meaningful because that means 80 percent of the variation in returns is not explained by CAPM. R²s below say 40 percent make the betas fairly meaningless. This is an admittedly arbitrary percentage, as

I am unaware of a hard and fast rule.

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DISCOUNTS FOR LACK OF MARKETABILITY/LIQUIDITY

Question 3: I've been asked to perform a valuation of two companies that are going to merge. Since the market for the two companies has already been established, is it appropriate *not* to take a marketability discount on either company? One company is going to acquire 100 percent of the stock of the other. Sorry, I haven't been able to find an answer to this in any of my texts.

Answer 3: According to the second edition of *Financial Valuation: Applications and Models*, "Marketability relates to the ability of an investor to convert the ownership interest to cash quickly, incur minimal transaction and administrative costs, and enjoy a relatively high degree of certainty of realizing the expected amount of net proceeds."¹

I think the valuation analyst has to be careful to consider the standard of value under which the valuation is being performed and which methodologies have been applied to determine the value of the companies.

If the standard of value is investment value, where there is a specific buyer, then there are certain assumptions that can be made that might steer the analyst away from using a DLOM. However, under a fair market value standard, some analysts believe that some level of DLOM might be appropriate when valuing a controlling interest. Looking at the definition above, the analyst should determine the relevance of applying a discount.

The other consideration has to do with methodologies. Many analysts believe that values derived using privately held transaction databases have a discount for lack of marketability already included in the value indication. However, that assumption does not exist if an income approach (using Morningstar or Duff and Phelps data) or a guideline public company method is used. If you don't reconcile the values from the various methodologies to a consistent level of value, you cannot derive a conclusion.

¹Hitchner, James R., *Financial Valuation: Applications and Models*. Second ed. Hoboken, N.J.: John Wiley & Sons, 2006. Print. Page 1157.

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