Jim Hitchner's Valuation Products and Services

VPS Q&A

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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Email your question to: jhitchner@valuationproducts.com

FLP DISCOUNTS

Question 1: Most of us rely on closed-end fund data to determine discounts for lack of control in FLPs that have marketable securities. Are there any recent studies that really tell us why there are discounts from net asset value (NAV) in closed-end funds?

Answer 1: Check out the Fall 2007 issue of *The Journal of Investing,* www.iijournals.com Institutional Investor, Inc. Journals Group, 225 Park Avenue South, New York, NY 10003 © 2008 Institutional Investor.

There is an article titled "The Structure of Closed-End Fund Discounts" by Bruce D. Niendorf and Kristine L. Beck, both associate professors of finance at the University of Wisconsin. I can't vouch for the article but it makes interesting reading. The authors state, "In recent years, discounts on closed-end funds of 10-15 percent have been the norm." They also pose various hypotheses when studying discounts on 46 closed-end domestic stock funds in 2004. Using regression analysis they studied the relationship of the size of the discount to various factors. A summary of the factors and their conclusions follows:

- Dividend yield - "... investors may seek compensation for dividend-related tax costs by paying less than NAV..."
- Discount variance- "....the discount may be caused in part by investors seeking to compensate themselves for the risk they bear due to fluctuations in fund market price..."
- Unrealized capital appreciation- "This study finds no support for...the idea that the larger a fund's tax liability [unrealized capital gains], the larger the compensating discount."
- Managerial performance- "The next hypothesis involves the relationship between managerial performance and the discount....This study finds no support for this hypothesis."
- Managerial expense ratios- "Hypothesis...relates managerial expense and the discount. If managerial fees are a dead weight loss, there should be a positive relationship between managerial fees and the discount. This study finds no support for this hypothesis."
- Trading volume - "If low liquidity contributes to inefficiency in asset pricing, then the greater (lower) the trading volume, the less (greater) the mispricing and resulting discount. This study finds no support for this hypothesis."
- Block ownership - "... if large block holders can use their voting power to secure private benefits that are not available to smaller investors, investors may discount the market price of the fund relative to NAV to recover the cost of the block holder's private benefits."
- Portfolio turnover - "The study finds no significant relationship between turnover and the discount."

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RATES OF RETURN FOR HIGHER RISK COMPANIES

***Question 2:* What information is out there for rates of return for higher risk businesses including venture capital return data?**

Answer 2: One of the most well known and often cited data sources is the *1987 QED Report on Venture Capital Financial Analysis* by James L. Plummer. It is dated and hard to find but is still relevant.

Professor Josh Lerner at Harvard Business School has compiled one of the most current, comprehensive bibliographies on venture capital as well as private equity analysis, available at http://www.people.hbs.edu/jlerner/bib.html

Professor Lerner also offers that the new textbook by Wharton's Andrew Metrick, *Venture Capital and the Finance of Innovation* (Wiley, September 2006) is definitely worth checking out, as it covers the relationship between risk and return in venture capital, historical statistics on V.C. investment performance, total and partial valuation methods and data, and more (available at www.amazon.com and most online sellers).

The HVA/VentureOne study examines private venture capital financing of high tech (electronic, semiconductor, software, and communications) and life sciences (biotechnology and medical devices) companies that went public from January 1993 to June 1997. *The Pricing of Successful Venture Capital Backed High Tech and Life Sciences Companies,* Houlihan Valuation Advisors/VentureOne Study, San Francisco, Ca. www.cogentvaluation.com/pdf/JournalofBusinessVenturing_VentureOne.pdf

William A. Sahlman and Daniel R. Scherlis wrote *A Method for Valuing High-Risk, Long-Term Investments: The Venture Capital Method*, 1987, revised 2003 www.harvardbusinessonline

Jeffry Timmons, a professor at Babson College, and Stephen Spinelli wrote *New Venture Creation: Entrepreneurship in the 21st Century, 7th ed.* (2006), McGraw Hill/Irwin. There is *Classic Venture Capital in the Next Millennium,* 1997 by William D. Bygrave, also of Babson College www.babson.edu

Tim Maio and William Pittock of Ernst & Young presented "Valuing Early Stage Life Sciences and Biotechnology" at the 5th Annual Joint ASA CICBV Advanced Business Valuation Conference in Orlando in October 2002. http://www.bvappraisers.org/contentdocs/Conference/Maio_Biotech_Final.pdf

Answer by: *Eva Lang, CPA/ABV, ASA, the Financial Consulting Group (Memphis), coauthor of The Best Websites for Financial Professionals, Business Appraisers and Accountants, Wiley www.gofcg.org and*

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PRACTICE AND RISK MANAGEMENT

***Question 3:* What expertise do BV people who do traditional entity business valuations have to value intangible assets such as customer lists, software, etc? What happens on the first *Daubert* challenge?**

Answer 3: Every professional has a duty to obtain appropriate skill, education and expertise in whatever professional service is offered. BV practitioners have a number of FV for Financial Reporting texts with which to train from. Further, all AICPA practitioners must comply with SSVS #1 regarding competency provision before accepting an engagement. *Daubert* challenges are limited to litigation, not financial reporting, but similar competency satisfaction must be presented. It would be a good idea to mentor with someone in this area as you gain experience.

Answer by: *Mike Mard, CPA/ABV, ASA, The Financial Valuation Group (Tampa), coauthor of Valuation for Financial Reporting, Fair Value Measurements and Reporting, Intangible Assets, Goodwill and Impairment, 2nd edition, 2007, Wiley, Appointed member of the FASB's Valuation Resource Group. mmard@fvginternational.com*

CONFLICTS OF INTEREST

Question 4: **I am involved in a divorce case where I represent the business-owner husband in valuing his business. The business is a tax client but not an attest client. The expert on the wife's side recently joined my firm as my employee. That employee has resigned from representing the wife. I wish to continue to represent the husband. I have offered to put up a Chinese wall between me and my employee on the case, but wife's attorney seeks to exclude me. What should I do?**

Answer 4: This scenario does happen from time to time. Since the new employee has resigned, there is no technical conflict of interest in your continuing to represent the husband. The employee (a CPA also) is bound by his/her CPA ethics to keep all information on his/her former client confidential and since the wife is no longer his/her client and never has been a client of yours, there should be no technical prohibition from your continuation to represent the husband. Having said that, there could be an appearance of a conflict of interest in this situation. It is possible that the court could exclude you, but that is a matter for the courts. Absent a court order to exclude you, you could continue to represent the husband, but you have to consider that a court might look askance at your continued representation given the circumstances. Therefore, you should discuss with your client and your client's attorney whether it is in the best interest of your client for you to withdraw from representation in the case also. [For another look at conflicts of interest and valuations for marital dissolution see *Financial Valuation and Litigation Expert,* Issue 10, December 2007/January 2008, "Conflict of Interest: Marital Dissolutions," by Scott Saltzman, CPA, CVA, ASA, DABFA

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