

Appraisal opportunities and challenges in down markets

By Tony Garvy¹

Since September 2008, the S&P 500 is down by an incredible 46 percent.² The stock market free fall has generated significant tax opportunities to business owners for gifting or selling closely held business assets. The free fall has also created substantial challenges to credibly appraise a privately held company interest, an important component to many tax strategies. By understanding the approach of appraisers to determining the value of closely held business in the current market conditions, estate planners can better service their clients during the market downturn.

The Good News: Gifting

The multiples appraisers are seeing on publicly traded guideline companies and closed end funds are unprecedented. The same dynamics that broadly drove down the equity markets are creating an environment that makes large gifting plans advantageous to the closely held business owner. Although it may be counter-intuitive to some clients who are hesitant to execute a large gifting plan with less personal liquidity, from a valuation perspective there is no better time than now to gift and execute estate planning techniques for privately held interests.

Appraisers are seeing lack of control discounts that were previously thought not possible. For example, some family limited partnerships that hold highly liquid assets may be subject to discounts for lack of control that are over 10 percent higher than just a year ago, as measured by closed end funds. The discounts from closed end funds have been increasing as the market has sold off precipitously. Closed end fund discounts have been customarily and historically used in determining a discount for lack of control. The IRS has accepted the use of closed end funds as a proper indicator for lack of control in many well known cases.³

The lower stock market value with larger pricing spreads is also a valid reason for a higher discount for lack of marketability. Initial public offerings ("IPO") and restricted stock studies⁴ have demonstrated an observed discount range of 15 percent - 75 percent. The IRS has argued that these historical studies have fundamental flaws. Although the

IRS has had little success in challenging historical studies' discounts in court, most appraisers tend to err on the conservative side. But marketability discounts should also reflect current conditions. In arriving at a proper discount for lack of marketability, many appraisers and courts use *Mandelbaum*⁵ factors, including the financial performance, dividend policy, holding period, and redemptions of stock. For privately held companies, the current downturn in the market restricts access to capital that could be used for expansion, dividend payments or stock redemptions, slows consumer and corporate spending that will affect future financial performance, and elongates the time to IPO (since fewer IPOs are even being underwritten). Therefore, an appraiser has possible arguments to raise the levels of discount for lack of marketability beyond the traditional rates.

The Ugly News: Dealing with low multiples in arriving at a credible valuation

The market is generating historically low multiples and discounts. However, does this reflect reality for privately held interests? Are closely held business assets inherently less valuable by 46 percent or more?⁶ This is the biggest theoretical struggle for appraisers.

The basic valuation formula is:

$$v = \frac{cf}{(k-g)}$$

Where:

- v = value of subject interest
- cf = cash flow (or other income benefit stream)
- k = discount rate (risk rate)
- g = growth rate

All three inputs (1) cash flow stream, (2) discount rate and (3) growth rate are never certain but are determined by the appraiser's professional judgment and the observed data in the subject company, its industry, marketplace and public markets. The discount rate can be the most difficult input to state accurately. With the current market downturn and lopsided underperformance from the

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financial industry sector, the appraiser needs to be thoughtful when generating a credible discount rate.

From the perspective of Chadwick & Garvy, we view this current downturn as an inverse of the telecommunications/Internet bubble of early 2000. At that time, the tele-com industry returns were skewing the market upward while other industry sectors were less upwardly volatile. Price earnings ratios of tele-coms were detached from underlying fundamental growth realities. Many appraisers at that time compensated for this "irrational exuberance" by modifying their discount rate to account for the upwardly volatile market.

Conversely, the financial sector is off over 70 percent from its highs.⁷ With the financial sector being within the top three weighted industry sectors over the last 20 years, the total market returns are skewed to the downside. Valuations are negatively affected because appraisers use discount rates derived from betas employed in the capital asset pricing model. Beta is a measure of systemic risk of a given stock or industry versus the market as a whole. But if the market returns are skewed, positively or negatively, due an inherently volatile industry, betas for the other industries are also influenced. A good appraiser should account for this distortion in the appraiser's analysis.

The question of whether a publicly traded company's multiples should be

affixed on a privately held company's earning streams without any adjustments for holding period is further tested in this environment. Is a privately held company truly worth over 50 percent less than it was just six months ago? The reality may be less stark. The same theory behind a lack of liquidity, that a privately held company takes many months to be properly marketed as opposed to publicly traded stocks that could be sold in seconds, could actually inure to the privately held investor's favor. For example, even if an owner of a privately held interest wanted to sell into this tough market, the owner couldn't do so. Granted much of this theory overlaps with the discount for lack of marketability. However we believe this longer sales holding period augurs for a higher multiple than the rock bottom multiples in the market today. This type of adjustment is dependant of the facts and circumstances of each appraisal and could be one of several adjustments to current market multiples (including any size adjustments, if appropriate, from the publicly traded guideline companies).

Appraising in this environment is tricky. To generate a sound, credible appraisal, the appraiser must address the extraordinary downward volatility in several key areas: discounts for lack of control, discounts for lack of marketability, choice of earnings multiple on the market approaches, and generation of a proper discount rate. There undoubt-

edly will be litigation and tax court cases dealing with appraisers who have not properly addressed the dynamic nature of the current market. Recent appraisals should demonstrate that the appraiser considered these issues.

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2. As observed in S&P 500 trading on March 16, 2009, was at 771.74, from its annual high of 1,440.24.

3. For example in the case of *Estate of Kelley v. Commissioner, T.C. Memo, 2005-235 October 11, 2005*, both the taxpayer and the IRS's experts stipulated their discount for lack of control came from discounts from net asset values of closed end funds.

4. Appraisers historically have used studies generated within the appraisal community regarding discounts from private placements of pre-IPO securities and restricted stock (subject to Rule 144A) as a way of measuring discount for lack of marketability.

5. These factors are from the case *Mandelbaum v. Commissioner T.C. Memo 1995-255*.

6. The I-shares Russell Micro Cap Index is off over 50 percent as of March 16, 2009. We believe this is one index that can approximate the return to smaller sized securities.

7. As observed from the XLF Financial Select SPDR from his annual high as of March 16, 2009.

The fine art of fine art investments

By Jesse T. Coyle

In recent years, fine art has increasingly been viewed as a wise alternative investment and as a means to better achieve diversification. The low correlation of fine art to more traditional markets and a reasonable risk to reward ratio makes it an attractive investment for some. But amateur investors should proceed with caution because the illiquidity of art and the irrationality in the art market makes it difficult to benchmark against more conventional investments.

The Numerous Benefits of Investments in Fine Art

Fine art as an investment can be very

attractive for several different reasons. First, fine art tends to have a low, and occasionally inverse correlation with many traditional investments, such as equities. Therefore, placing fine art in your portfolio can mean better diversification and can possibly hedge against some stock market fluctuations. Second, for those that find fine art appealing, investing in fine art is not merely a financial investment, but also a personal investment. Unlike shares of stock that cannot be enjoyed separate from their financial characteristics, artwork provides often unmatched aesthetic pleasure. So not only is it an investment that can increase your net worth over time, it is

also a way to add beauty to your home and increase the artistic appreciation within your family. Third, as the popularity of investing in art has increased, so has the availability of art related investments and art advisors. Notably there are fine art investment opportunities apart from simply purchasing an individual painting or sculpture for your home such as investing in various art indexed funds. And when considering whether to purchase a piece of art, there are a multitude of advisors that can assist you in this endeavor. Most of these advisors provide fee-based services.

The Mei/Moses Fine Art Index can be utilized to assess the value of the fine art