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POST FINANCIAL CRISIS AND ITS EFFECT ON APPRAISING

Abstract: This article discusses appraising based on post financial crisis market levels. There are unique issues to this downward market that every appraiser should prudently assess in arriving at a credible value.

Since September 2008, the market is off an incredible 46%¹. This market free fall yields incredible opportunity and challenges for the appraiser in determining a credible valuation of a privately held company interest. It is important that every appraisal report deals with this profound fact. Below are our thoughts concerning how we look at appraising in this volatile and downward trading environment.

The Good News: Gifting

The multiples we are seeing on publicly traded guideline companies and closed end funds are unprecedented. The very dynamics which are making some clients hesitant about executing large gift plans, i.e. less personal liquidity, the desire to cut back on fee expenditures and less desire to plan for the future, are the same concerns and qualities driving down the equity markets. However, for certain, there is no better time to gift and execute estate planning techniques for privately held interests from a valuation perspective.

We are seeing discounts that previously were thought not to be possible. For example, some Family Limited Partnerships interests holding highly liquid underlying assets, depending on the facts and circumstances, may be subject to discounts for lack of control, as measured by closed end funds, well over 10 percent higher than just a year ago. The discounts from these closed end funds have been increasing as the market has sold off precipitously. These discounts have been historically used in the past in determining a proper discount for lack of control. In fact, many well known court cases have underscored the IRS acceptance of the use of closed end funds as a proper indicator of the discount for lack of control.²

We believe that this lower market with larger pricing spreads is also a valid reason for a higher discount for lack of marketability. With the historical initial public offering

¹ As observed in trading on March 16, 2009, the S&P 500 was at 771.74, from its 52 week high of 1,440.24.

² 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.

(“IPO”) and restricted stock studies³ demonstrating an observed discount range of 15 % – 75%, many appraisers have been accustomed to being on the conservative side. With the Internal Revenue Service trying to argue that these historical studies have fundamental flaws, albeit with very limited success, most appraisers tend to stick in a comfort zone. But this environment affects both discounts for lack of control and marketability. We view that marketability discounts should also reflect current conditions. In arriving at a proper discount for lack of marketability, many appraisers and courts use *Mandelbaum* factors.⁴ These factors include accounting for the financial performance, dividend policy, holding period, and redemptions of stock. The current downturn in the market has direct effects on privately held companies such as restricted access to capital that could be used for expansion, dividend payments and stock redemptions, slower consumer and corporate spending that will affect future financial performance of privately held companies, longer times to IPO (since fewer IPOs are even being underwritten). Therefore, based on the current market downturn an appraiser has possible arguments to raise the levels of discount for lack of marketability.

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

The market is generating obviously historically low multiples and discounts. However, does this reflect reality for privately held interests? Are they inherently less valuable by 46% or more?⁵ 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, cash flow stream, discount rate and growth rate are never certain but are determined by the appraiser’s professional judgment from the observed data in the subject company, its industry, marketplace and public markets. The discount rate can be

³ 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.

⁴ These factors are from the case *Mandelbaum v. Commissioner T.C. Memo 1995-255*.

⁵ The Ishares 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.



the toughest of the three and with the current market downturn and lopsided underperformance from the financial industry sector; the appraiser needs to take this into account in generating a credible discount rate.

From our perspective, we view this current downturn as a similar to the inverse of the tele-communications / internet bubble of early 2000. At that time, the tele-com industry returns were skewing the market upward and other industry sectors were less upwardly volatile. Price earnings ratios were detached from underlying fundamental growth realities. Many appraisers back then compensated for this “irrational exuberance” by modifying their discount rate to account for that upwardly volatile market.

The financial sector is off over 70 percent from its highs.⁶ With the financial sector being within in the top three weighted industry sectors over the last 20 years, the total market returns are clearly skewed to the downside because of this sector. This has an adverse affect on valuations 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, positive or negative, are skewed due an inherently volatile industry, then Betas for the other industries are also affected. Therefore an appraiser has to account for this in their analysis.

The unending discussion 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 tough environment. Is a privately held company truly worth over 50 percent less than it was just six months ago? Well we believe the reality is less stark than that. The same theory behind a lack of liquidity – that a privately held company takes many months if not well over a year 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, he or she couldn’t do so. Granted much of this is the theory behind the discount for lack of marketability. However we believe this longer holding period augurs for a higher multiple than the rock bottom multiples in the market today. This type of adjustment is dependent on 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).

In our appraisals we address the current market downturn from both market approaches and the income approaches. Both market multiples and the discount rates employed in our income approach we generate are tempered by the reality that the financial industry has had a large influence in skewing the market derived betas for all sectors. We firmly believe any credible appraiser has to speak to these issues in their report.

⁶ As observed from the XLF Financial Select SPDR from its 52 week high as of March 16, 2009.



Appraising in this environment is tricky. To generate a sound, credible appraisal, the appraiser must address this extraordinary downward volatility in several key areas: discounts for lack of control, discounts for lack of marketability, earnings multiple selection on the market approaches and generation of a proper discount rate. No doubt there will be litigation and tax court cases dealing with appraisers who have not properly addressed the dynamic nature of our current market – be sure the appraisals for your clients' interests does address these issues.