MERCER CAPITAL

VALUE ADDED™

Business Valuation • Investment Banking No. 1 Volume 17 • 2005

Headquarters:
5860 Ridgeway Ctr. Parkway
Suite 400
Memphis, TN 38120
Phone: 901.685.2120
Fax: 901.685.2199

Midwest Office:
511 South 5th Street
Suite 206
Louisville, KY 40202
Phone: 502.585.6340
Fax: 502.585.6345

mcm@mercercapital.com
www.mercercapital.com

IN THIS ISSUE

When is Fair Market Value Determined? *Estate of Helen M. Noble v. Commissioner*. . . . 1

Recent Transactions. 1

Deal Expert vs. Industry Expert . . . 3

Mercer Capital Highlights 3

Mercer Capital Advisors Update: *Current Offerings* . . 6

MERCER CAPITAL

When is Fair Market Value Determined?

Estate of Helen M. Noble v. Commissioner

In *Estate of Noble v. Commissioner*[1], the Tax Court gave little attention in its 30-page opinion to the reports of two experts. Instead, it focused the decision on a discussion of a sale of the subject block some 14 months after the date of death (the valuation date). Two important issues are raised by *Noble*.

1. The relevance of post-valuation date transactions or events ("subsequent events") in determining the fair market value of non-publicly traded interests; and,

2. The meaning of the concept of "arm's length transactions" in the context of determinations of fair market value.

This article addresses both issues in the context of *Noble* and within one appraiser's understanding of the meaning of fair market value.

Case Background. The subject of the valuation was 116 shares of Glenwood State Bank ("the Bank"), representing 11.6% of its 1,000 shares outstanding at September 2, 1996, the date of death of Helen M. Noble ("the Estate"). The Bank was a small ($81 million in total assets), over-capitalized (17.5% equity-to-assets ratio), low-earning bank (3% to 5% return on equity for the last four years) located in rural Glenwood, Iowa. Historical growth of the balance sheet had been anemic prior to the valuation date, and prospects for future growth were similar. Management's philosophy, implemented over many years, was to reinvest all earnings back into the Bank and to pay no shareholder dividends. There was no market for the Bank's shares.

The Estate's 11.6% block of the Bank's stock was the only block of the Bank that Glenwood Bancorporation, the parent holding company ("the Company"), did not own at the valuation date. The Company had, over a period of many years, gradually consolidated its ownership of the Bank to this point. The Company's historical philosophy had mirrored that of the Bank, and no dividends were paid historically or anticipated for the near future.

In short, the subject 11.6% interest in the Bank was not a very attractive investment, when viewed in terms of then-current expectations for growth, dividends, and overall returns for publicly traded bank shares.

Two appraisals were submitted to the Tax Court in this matter:

(Continued on Page 2)

Transactions

Wittichen Lime & Cement Co., Inc.
Memphis, Tennessee

has been acquired by

General Shale Brick, Inc.
Johnson City, Tennessee

Mercer Capital Advisors
acted as financial advisors
to Wittichen Lime & Cement Co., Inc.

Magnolia Masonry Products, LLC
Tupelo, Mississippi
and Oxford, Mississippi

has been acquired by

General Shale Brick, Inc.
Johnson City, Tennessee

Mercer Capital Advisors
acted as financial advisors
to Magnolia Masonry Products, LLC

Mercer Capital Advisors provides investment banking and transaction advisory services to the middle market. For a listing of successful transactions, please visit our website at **www.mercercapital.com**.

> "...the Tax Court gave little attention in its 30-page opinion to the reports of two experts. Instead, it focused the decision on a discussion of a sale of the subject block some 14 months after the date of death..."

- *Internal Revenue Service.* William C. Herber of Shenehon & Company ("Herber") presented a valuation which concluded that the fair market value of the subject 11.6% interest in the Bank was $1,100,000, or $9,483 per share. The marketable minority value concluded by Herber was $13.1 million, and his marketability discount was 30%.

- *The Estate.* Z. Christopher Mercer, ASA, CFA of Mercer Capital ("Mercer", the writer of this article) presented an appraisal which concluded that the fair market value of the subject interest was $841,000, or $7,250 per share. The marketable minority value concluded by Mercer was $12.7 million, and his marketability discount was 43%.

In addition, the Bank had obtained an appraisal from Seim, Johnson, Sestak & Quist, LLP, an accounting firm, of the fair market value of the same shares as of December 31, 1996 ("the Seim Johnson Report"). This report (issued May 15, 1997) concluded that the fair market value of the shares was $878,004 ($7,569 per share). The Estate originally reported the fair market value of the shares at $903,988 ($7,793 per share based on then-current book value less a minority interest discount of 45%). The Estate sold its 116 shares to the company on October 24, 1997, almost 14 months after the valuation date, for $1.1 million.[2]

Focusing on the expert reports of Herber and Mercer, the total difference in value between the two appraisals of the 11.6% interest was $259,000. Herber's result was about 30% higher than Mercer's. Relative to many valuation disputes, the differences were fairly small. Both appraisers agreed on the relative unattractiveness of the subject shares as an investment. Herber's appraisal represented 73% of the Bank's book value, while Mercer's appraisal represented 56% of book value.

Given the similarity of conclusions at the marketable minority level, the major difference in valuation conclusions between the two appraisers was the difference in their concluded marketability discounts. This was an opportunity for the Court to address this issue in a meaningful way; however, that did not occur. We present information here not found in the Tax Court opinion.

Relevence of Subsequent Events. After discussing two sales of minority interests of the Bank's stock, one of which occurred some 15 months *prior* to the valuation date (at $1,000 per share), and the other of which occurred about two months prior to the valuation date ($1,500 per share), the Court's decision notes:

> As to the third sale, which occurred on October 24, 1997, approximately 14 months *after* the applicable valuation date, we disagree with petitioners that only sales of stock that predate a valuation date may be used to determine fair market value as of that valuation date. The Court of Appeals for the Eighth Circuit, the court to which an appeal of this case most likely lies, has held specifically that "In determining the value of unlisted stocks, actual sales made in reasonable amounts at arm's length, in the normal course of business, *within a reasonable time before or after* the basic date, are the best criterion of market value."[3] [citations omitted, emphasis added][4]

The Court made no mention as to what constitutes a "reasonable time" before or after a valuation date. It went on to say, after further discussion of the subsequent transaction, that:

> When a subsequent event such as the third sale before us is used to set the fair market value of property as of an earlier date, adjustments should be made to the sale price to account for the passage of time as well as to reflect any change in the setting from the date of valuation to the date of sale. [citing *Estate of Scanlan*] These adjustments are necessary to reflect happenings between the two dates which would affect the later sale price vis-à-vis a hypothetical sale on the earlier date of valuation. These happenings include: (1) Inflation, (2) changes in the relevant industry and the expectations for that industry, (3) changes in business component results, (4) changes in technology, macroeconomics, or tax law, and (5) the occurrence or nonoccurrence of any event which a hypothetical reasonable buyer or hypothetical reasonable seller would conclude could affect the selling price of the property subject to valuation (e.g., the death of a key employee [citing *Estate of Jung*].
>
> *The record before us does not establish the presence of any material change in circumstances between the date of the third sale and the applicable valuation date.* [emphasis added][5]

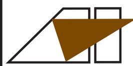
The Court noted that the 116 shares sold for a total of $1.1 million, or $9,483 per share, on October 24, 1997. In response to the above guidance regarding "the happenings between the two dates" the Court stated: "While the record does not accurately pinpoint the appropriate rate to apply for that purpose [inflation], the Bureau of Labor Statistics has stated that the rate of inflation during each of the years 1996 and 1997 was slightly less than 3 percent."

The five factors noted above are now considered:

1. *Inflation*. The Court did its own independent research on inflation, lowering the subsequent transaction price to $1,067,000 ($1,100,000/(1 + 3%)). This reduction of $33,000, or $284 per share, was made by the Court to account for the effect of inflation during the period between the valuation date and the date of the subsequent transaction despite specific expert advice arguing against the appropriateness of this adjustment for the change in inflation.[6]

2. *Changes in the Relevant Industry and the Expectations for that Industry*. The Court made no investigation of changes in industry performance. However, the banking industry experienced very strong results in the

(Continued on Page 4)



Deal Expert vs. Industry Expert

One of the most frequent issues addressed when talking with business owners relates to the financial expertise that may be appropriate for specific transaction requirements. The basic question often boils down to: Should we hire an *industry expert* for this engagement, or is it preferable to hire a "*deal expert"* with experience in completing hundreds of transactions and engagements in a myriad of industries?

Industry Expertise vs. Deal Expertise. There are literally hundreds of industry categories and subcategories. There are, in fact, more industry categories than there are corresponding industry specialists. Many, if not most, industry subcategories do not have industry specialists. There simply are not enough businesses in these categories to enable specialization by investment banking professionals. In small industries or industry subcategories, business owners are likely to be referred to a deal expert. If an industry is large, it is often possible to find several or too many industry experts. No matter the size of the industry, if you go with an industry expert to value and sell your or your client's business, be sure that the expert also has *deal expertise*. Lessons learned by way of engagements across multiple industry sectors are too valuable to lose when "your" deal needs negotiating.

Deal Expertise. Deal expertise is attained from years of hands-on experience and knowledge of financial markets. As business valuators and investment bankers, we are knowledgeable about valuation methods and techniques. Deal and valuation expertise also includes a working knowledge of complex financial theory. This enables us, as deal experts, to learn new industries quickly.

For example, at Mercer Capital, we have provided transaction advisory services and/or valuation services in more than 500 industry categories and subcategories. Along the way, we have developed specific expertise in a number of industries, including financial institutions, auto dealerships, manufacturing-related companies, distribution-related companies, construction-related companies, service companies, and certain areas of health care.

If you are confused about whether to choose an industry expert or a deal expert, keep the following things in mind:

- *A deal expert has a wide set of relationships*. An industry expert is such because they have knowledge of certain strategic buyers within the industry. However, their knowledge of possible buyers outside the industry is sometimes limited. Deal experts not only pinpoint strategic buyers within the industry but have relationships with other potential buyers, such as private equity groups. In fact, in many of the deals in certain industries we have seen recently, private equity groups have paid more than strategic buyers. Historically, this has not always been true but why not consider this if the opportunity is there.

- *A deal expert has "seen it."* Because of the broad experience possessed, deal experts have seen a wide set of business scenarios in diverse, as well as common, business models. This range of experience can be of great help if and when there are unexpected issues that arise, as they almost always do. The deal expert will be able to deal with each issue and move the deal to completion.

- *A deal expert is also a financial expert.* The components of a transaction are quite often complicated. A deal expert has the financial acumen to obtain the best financial outcome for the client because the deal expert possesses an understanding of the pecuniary intricacies of the deal.

We believe we can say that, based on over 20 years of experience, *deal expertise,* combined with a broad base of industry experience, is a preferable experience set than purely industry expertise. If a referring professional or a direct client can obtain both sets of qualifications in one firm, so much the better.

Conclusion. We believe you should expect your investment banker to be a *deal expert* and to have knowledge of a broad base of industries. If you are considering an industry expert versus a deal expert, you owe it to yourself to achieve the added value our deal expertise can earn for you. Let us come and visit with you when you are contemplating a transaction. You will not be disappointed.◆

Mercer Capital Highlights

Announcements:

Mercer Capital is pleased to welcome ***Kristin P. Cicala*** to our professional staff as a financial analyst. Ms. Cicala comes to us from the University of Memphis.

Speaking Engagements:

May 18, 2005
MSCPA Program for Management Development
Jackson, MS
"Understanding Value and Forming Rational Expectations When Selling Your Business or Making an Acquisition"
Timothy R. Lee, ASA and Brent A. McDade

May 19, 2005
GSCPA Business Valuation Conference
Atlanta, GA
"The Integrated Theory of Business Valuation"
Z. Christopher Mercer, ASA, CFA

May 20, 2005
National Association of Personal Finance Advisors
Tampa, FL
"Business Succession and Exit Strategies"
Z. Christopher Mercer, ASA, CFA

Value Added™

"One of the most frequent issues addressed when talking with business owners relates to the financial expertise that may be appropriate for specific transaction requirements"

"If one is to consider a subsequent transaction directly in an appraisal as of a specific date, what is a 'reasonable time' for consideration of that transaction? Evidently, 14 months was 'reasonable' to the Court. What about two years?"

Fair Market Value

(Continued from Page 2)

public markets between September 2, 1996 and October 24, 1997, with the NASDAQ Bank Index increasing some 75% over the period. This compared with a 45% increase in the S&P 500 Index over the same period. So the base market evidence used by both appraisers would have shown considerably higher price/earnings multiples and price/book multiples 14 months later. This certainly could have had an influence on value at the time of the subsequent sale. Clearly, consideration of the change in market conditions could have had a significant impact on value during the interim period, and should be taken into account if one is considering a subsequent transaction as direct evidence of fair market value as of an earlier date. The Court did not do this, citing the absence of such post-valuation date evidence in the record. Were the appraisers somehow at fault for not discussing post-valuation date market performance? More frequently, appraisers are criticized for engaging in such analysis.

3. *Changes in the Business Component Results*. The Court made no investigation of changes in business component results. However, it is clear from the record that the Bank was earning at the rate of about $700,000 per year and paying no dividends to shareholders, so just over a year later, its book value would have been about $700 per share higher. This foreseeable change, which was noted in the Mercer Report, was not considered by the Court.

4. *Changes in Technology, Macroeconomics, or Tax Law*. The Court did no investigation of changes in these factors. Suffice it to say that there were almost certainly changes in one or all of these areas.

5. *The Occurrence (or Nonoccurrence) of Events that Reasonable Investors Would Consider Impact Value*. The Court *did consider* the subsequent sale of 116 shares of the Bank by the Estate. However, the Court *did not consider* another subsequent event which occurred virtually simultaneously with the subsequent transaction, that materially changed the value of the 116 shares of the Bank. The Company, decided that it wanted the Bank to pay dividends after many years of not paying dividends. As discussed in the Mercer Report, there was a strong aversion to paying dividends from the Bank to the Company. This change of philosophy would also have changed the amount that the company was willing to negotiate for a transaction for the 116 shares of the Bank's stock. Immediately after the transaction, when the Company owned 100% of the Bank's shares, a dividend of $1,200,000, or $1,200 per share on the previously outstanding 1,000 shares was paid (between October 24, 1997 and December 31, 1997). This dividend, if received by the Estate as a continuing shareholder, would have represented a yield of 12.7% based on the subsequent transaction price of $9,483 per share. As was discussed in the Mercer Report and in Mercer's trial testimony, this change had the effect of creating a significant change in the value of the shares relative to September 2, 1996.[7]

Neither Mercer nor Herber provided an analysis of events in the stock market, in the market for bank stocks, or of detailed financial performance of the Bank subsequent to the valuation date. Both appraisers were providing valuation opinions as of September 2, 1996. Mercer mentioned the subsequent transaction in his report, and both appraisers mentioned the transactions prior to the valuation date. The Mercer Report discussed the subsequent change in dividend policy in detail.

It should be clear from the above analysis of the factors mentioned by the Court, that there were material changes, virtually all positive regarding the value of 116 shares of the Bank, between the valuation date of September 2, 1996 and the subsequent transaction on October 24, 1997.

The Court's analysis of subsequent transactions raises several questions:

- If one is to consider a subsequent transaction directly in an appraisal as of a specific date, what is a "reasonable time" for consideration of that transaction? Evidently, 14 months was "reasonable" to the Court. What about two years? Or three years or more?
- When is a valuation over?
- Is there a need for a revaluation in light of the five guidance factors above every time appraisers encounter subsequent transactions?
- What is an appraiser who is valuing a business or business interest as of a current valuation date to do regarding subsequent transactions that have not occurred when he or she is rendering the opinion?[8]
- Is it reasonable to impeach an appraisal done timely based on transactions that occur subsequent to the valuation date? After all, neither the appraiser conducting such a timely appraisal nor hypothetical or real willing buyers and sellers would have had knowledge of such subsequent events.
- Do real-life investors have the opportunity for such a free look-back?[9]
- Is the consideration of subsequent events as "evidence of fair market value" as of an earlier date merely a way for an appraiser or a court to reach a pre-determined conclusion?
- The underlying question is, what kind of analysis does the Tax Court desire in a determination of fair market value as of a given valuation date?

It is this author's understanding of the investment process that investors consider all relevant information, including that which is known and that which is reasonably foreseeable, or reasonably

knowable, up to the moment that an investment is executed. After that, there are no second chances. Real-life investors know that one of only two things will happen with respect to the return performance of any particular investment:

- It will perform at less, equal to, or greater than the original expectations over the expected investment horizon; or
- The actual investment horizon will be shorter or longer than original, expected investment horizon, and performance will be equal to, less than or greater then original expectations.

The investment's ultimate performance will be the (net) result of many factors, including the actual performance of the underlying entity, changes (favorable or unfavorable) in national economic conditions or specific industry conditions, the general level of the stock markets and the particular performance of a particular industry, and the other factors noted above.

The Court's decision in *Noble* causes great uncertainty for both appraisers and taxpayers.

Arm's Length Transactions. The second fundamental issue in *Estate of Noble* relates to the nature of arm's length transactions. This author understands the nature of the standard of value known as fair market value to consist of:

- A hypothetical willing buyer and a hypothetical willing seller (presumably independent of each other),
- Both of whom are fully (or at least reasonably) informed about the subject of investment,
- Neither of whom is acting under any compulsion,
- And both of whom have the capacity to engage in a transaction involving the subject interest,
- Engage in a hypothetical transaction at the fair market value (cash-equivalent) price.

A Four-Factor Test for Bargaining Parity. A transaction involving the characteristics noted above would be an "arm's length" transaction in the context of fair market value. Fair market value transactions presume bargaining parity. Note from this definition that an actual transaction in non-publicly traded stock would not meet the definition of arm's length transactions in the context of fair market value if one or more of the following four conditions of bargaining parity are not met:[10]

1. ***Independence.*** If parties are related in some way, it is clear that transactions between them should be viewed with skepticism. It is simply not possible to know the extent of relationships or how those relationships could impact the pricing of a particular transaction.
2. ***Reasonably and Equally Informed.*** If both parties are not reasonably (equally) informed about the facts and circumstances related to the investment, a transaction should also be viewed with skepticism. Clearly, if one party has a significant information advantage over the other, a transaction is not likely to occur at fair market value, since the party lacking the information lacks equal bargaining power. As will be shown below, the Court did not consider a known inequality of information with respect to the third transaction which should have excluded it from consideration as evidence of fair market value *at any time*.
3. ***Absence of Compulsion.*** If one or both of the parties is acting under any compulsion to engage in a transaction, it is generally understood that a transaction is not evidence of fair market value. A party acting under compulsion would lack parity in bargaining power relative to the party who can view the investment opportunity dispassionately and objectively.
4. ***Financial Capacity to Transact.*** If one party lacks the financial capacity to engage in a transaction, the results of negotiations may not reflect equal bargaining power.

It will be helpful to review the concept of arm's length transactions in the context of these four essential elements of bargaining parity, i.e., through the four factor test outlined above. Although this test was not employed explicitly in this manner in the Mercer Report, it was employed implicitly in the discussion and analysis of the three transactions.◆

Z. Christopher Mercer, ASA,CFA
mercerc@mercercapital.com

This is the first of a two part article. Next quarter's issue of Value Added™ will discuss the case from a different perspective.

1 *Estate of Helen M. Noble v. Commissioner*, T.C Memo. 2005-2, January 6, 2005.

2 In the final analysis, this fact was determinative of value in the Court's decision. There was surprisingly little discussion of any of the three valuation reports before the Court in *Noble*.

3 The Herber Report did not mention the subsequent transaction. The Mercer report mentioned the subsequent transaction, but did not rely on it in reaching its appraisal conclusion. Herber's conclusion, however, was identical to the value of the subsequent transaction. Mercer's report analyzed the subsequent transaction and placed it into perspective with his valuation-date conclusion, indicating that circumstances had changed between the valuation date with respect to expected dividend policy at Glenwood Bancorporation (and therefore, with respect to Glenwood Bank). Mercer noted that while Glenwood Bancorporation knew of this change in policy, it was not communicated to the Estate's representatives prior to the transaction.

4 *Supra*. Endnote I, pp. 21-22.

5 *Supra*. Endnote I, pp. 28-29.

6 The Court asked Mercer a direct question on the appropriateness of discounting a subsequent transaction to the valuation date "at interest."

THE COURT: Okay. Another question for you. I asked you earlier about the possible use of the October transaction as a potential for a valuation. If one wanted to look at that and factor in an interest rate what rate would you use in order to factor that in?

THE WITNESS: Well, let me answer it just one other – one slightly different way. If you look at our valuation, my valuation, that 841,000, and I understand that Mr. Herber's problem with talking about I and we, because we do that as firms, and you apply a 17 percent rate of return you would get to about , oh, a million. The 1.1 million, the 1.14 years implies about a 25 of 26 percent rate of return. That would not be unusual for an earlier [than anticipated] transaction.

THE COURT: But you are looking at a rate of return. I am simply saying wouldn't you just factor, couldn't one just factor in an interest rate, in other words, like a discount rate for time value of money?

THE WITNESS: Well, no, because the fact of the matter is an interest rate for the time value of money would not include premium for the risk of

"The Court's decision in *Noble* causes great uncertainty for both appraisers and taxpayers."

MERCER CAPITAL
5860 Ridgeway Center Parkway, Suite 400
Memphis, Tennessee 38120

PRSRT STD
AUTO
U.S. POSTAGE PAID
Memphis, TN
Permit No. 29

VALUE ADDED™

In This Issue...

When is Fair Market Value Determined?
Estate of Helen M. Noble v. Commissioner

Recent Transactions

Deal Expert vs. Industry Expert

Mercer Capital Highlights

Mercer Capital Advisors Current Offerings

Fair Market Value

(Continued from Page 5)

holding the stock for that period of time. So at the very least if you were going to do that to reverse back to the present you would build up a discount rate to 16, 18, 20 percent, or 26 percent, or some number, and bring that back to the present. The time value of money would not account for that risk.

THE COURT: Okay.

THE WITNESS: When you buy stock now, you have the risk going forward, and you don't know about the transaction.

[7] Clearly, the conclusions of both appraisers would have been higher had there been any reasonable expectation of such dividends in the readily foreseeable future.

[8] As with the Seim Johnson Report, which was issued five months prior to the October 1997 transaction, and, obviously, did not take the potential subsequent transaction into account.

[9] The answer to this question is "obviously not."

[10] Mercer Z. Christopher, *Valuing Enterprise and Shareholder Cash Flows – the Integrated Theory of Business Valuation* (Memphis, TN: Peabody Publishing, 2004).

Are You Blogging?

www.merceronvalue.com

Mercer Capital Advisors Update

We are currently offering the following profitable companies to qualified prospects

- **Nationwide Telecommunications Service Provider** specializing in site acquisition, zoning services, construction management and tower management

To obtain a company profile, visit our website at www.mercercapital.com

For additional information,
call Nicholas J. Heinz at 901.685.2120 or
e-mail him at heinzn@mercercapital.com.

Copyright © 2005 Mercer Capital Management, Inc. All rights reserved. It is illegal under Federal law to reproduce this publication or any portion of its contents without the publisher's permission. Media quotations with source attribution are encouraged. Reporters requesting additional information or editorial comment should contact Barbara Walters Price at 901.685.2120.

Value Added™ is published quarterly and does not constitute legal or financial consulting advice. It is offered as an information service to our clients and friends. Those interested in specific guidance for legal or accounting matters should seek competent professional advice. Inquiries to discuss specific valuation matters are welcomed. To add your name to our mailing list to receive this complimentary publication, visit our web site at www.mercercapital.com.