MASTERING THE ART OF BUSINESS VALUATION: THE CRITICAL ROLE OF COMPARABLE COMPANIES

As the owner of a privately held enterprise, understanding your business's worth becomes pivotal whether you're considering a sale, attracting new investments or facing legal and tax obligations.

Business appraisers employ a blend of the three most common valuation approaches when determining the “fair market value” of a company. These approaches are referred to as the Income, Market and Cost Approaches. The guideline public company method of the Market Approach evaluates your business's worth through comparative analysis of similar publicly traded businesses, commonly known as "comps", using publicly available data. Theoretically, if it can be reasonably demonstrated that your company is comparable to the comps by some measure, then it stands to reason that similar valuation multiples would apply, thereby providing an indication of value for the company.

When using the guideline public company method of the Market Approach, the appraiser diligently searches for public companies that are comparable to your business. Because no two businesses are identical, the appraiser will exercise judgment when selecting comps that can provide meaningful, relevant evidence of the value of your business. The comparative metrics are vast and are only limited by quality and availability of data; industries and markets served, customer profiles, revenue, profitability, growth expectations, geographic breadth, product/service diversity, placement amongst the innovation curve within the subject industry, etc. tend to be some of the most common attributes analyzed when attempting to both identify comps and when comparing selected comps to a subject company.

Selection Criteria

Business valuation guidance and U.S. Tax Court cases have identified several factors to consider when selecting comps, including:

Industry and Markets Served

Product and Service Offerings

Nature of Competition

Geographic Location

Earnings and Dividend-Paying Capacity

Capital Structure

Credit Status

Maturity of the Business

Management Depth and Experience

Considering that no two businesses are identical, Internal Revenue Code § 2031(b) directs the appraiser to consider publicly traded companies "engaged in the same or a **similar** line of business" as yours. Particularly when selecting publicly traded comps, it is often the case that the publicly traded company has greater revenue, more diverse product or service offerings and wider geographic breadth. However, the appraiser's primary objective remains to align the underlying economic dynamics that drive those businesses with those of your own.

Real World Examples

When a business appraisal is prepared for tax or litigation purposes, both the appraiser and, ultimately, the business owner should be prepared to substantiate their choice of comps or face potential challenges from the IRS or even the exclusion of the appraisal from consideration. One real-world example that illustrates that the selection of comps is unique to each business lies in the Tax Courts' stance: while they have rejected the use of a single comp to demonstrate value, they have alternatively accepted and rejected the reliance on only two comps.

In Hall v. Commissioner, the IRS applied the market approach to gauge the value of Hallmark, citing American Greetings as the sole comp, stating it was "the only reasonably comparable company to Hallmark[1]." However, the Tax Court rejected this approach, citing that individual company traits could skew the comparison, emphasizing that one company's success in an industry might come at the expense of its rivals.

Similarly, in Heck v. Commissioner[2], the Tax Court rejected the IRS's use of the market approach in valuing a champagne producer based solely on two wine producers. While prior appraisals based on two comparable companies had been accepted, the Court differentiated the cases, emphasizing that all three companies previously accepted were directly aligned in business activities, whereas the ones in question were only loosely similar. Most notably, the Court stressed that as the resemblance to the company being valued diminishes, the necessity for more comparables increases to mitigate the risk of distortion due to unique attributes of each guideline company.

Conclusion

Failure to apply relevant selection criteria when identifying comparable companies can lead to an inaccurate appraisal value, undermining the credibility of the appraiser's findings. Precision is paramount. Since you know your business best, the appraiser may solicit your input to ensure that the selected comps genuinely reflect the value of your business.

[1] 92 T.C. 312 (1989)
[2] T.C. Memo. 2002-34 (2002).