Comparability of Guideline Publicly Traded Companies in the Valuation of Atypical Companies

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A valuation analyst may be retained to value a wide variety of companies for gift and estate tax planning, compliance, or controversy purposes. Such companies may offer unusual products or services (i.e., atypical companies). Regarding the application of the market approach and guideline publicly traded company method in the valuation of an atypical company, there may be an absence of guideline publicly traded companies with products and services that are sufficiently comparable to those of the atypical subject company. In these instances, the analyst can either (1) reject the application of the guideline publicly traded company method or (2) broaden the selection criteria to related industries. Two Tax Court decisions have outlined lists of factors to consider when analyzing the comparability of guideline publicly traded companies. Additionally, several Tax Court decisions have provided insight into the degree of comparability accepted by the Tax Court. The analyst should consider these Tax Court decisions and selection criteria when applying the guideline publicly traded company method in the valuation of an atypical company.

Introduction

A valuation analyst (analyst) may be retained to value a wide range of companies for gift and estate tax planning, compliance, and controversy purposes.

Valuation engagements may pertain to companies in emerging industries or niche markets, and the analyst may find very little data to rely on throughout the valuation engagement.

This discussion focuses on the application of the guideline publicly traded company (GPTC) method in the valuation of atypical companies. In this discussion, we consider atypical companies to be companies that offer unusual products or services and that have very few direct competitors.

For example, let's consider the following information pertaining to a hypothetical valuation assignment of a hypothetical atypical company, Eyeball Design, Inc. ("Eyeball Design"). The valuation purpose is for estate tax planning.

The analyst has ascertained the following facts about Eyeball Design:

1. Eyeball Design manufactures nonfunctional prosthetic eyeballs. These prosthetic eyeballs do not have any function beyond aesthetics and do not enable patient vision in any way.
2. In the process of creating nonfunctional prosthetic eyeballs, Eyeball Design starts by taking detailed specifications and measurements of the patient. Eyeball Design then sends these measurements to an outside manufacturer that creates ceramic shells based on these measurements.

   Eyeball Design employees then complete the prosthetic eyeball by handpainting these prosthetic shells to match the preferences of the patient.

3. There are fewer than 300 prosthetic eyeball manufacturers in the United States.
4. Prosthetic eyeball manufacturing is very different than the manufacturing of other prosthetic appendages. These differences include (a) manufacturing processes, (b) profitability, and (c) relationships with medical facilities and insurance companies. The fixed assets of Eyeball Design resemble those of an art studio.
5. There are no publicly traded prosthetic eyeball manufacturers.

The valuation of an atypical company such as Eyeball Design involves challenges related to the lack of data. Particularly, the analyst may encounter challenges in the selection of GPTCs in the application of the market approach GPTC method.

If an analyst relies on data from GPTCs that are not similar to the company being valued, the analyst risks potentially overvaluing or undervaluing the company and having the value indication from this valuation method disregarded by the Tax Court.

When performing valuations of atypical companies, the analyst should consider both the selection of GPTCs and the weighting of the GPTC method.

Valuation Approaches

When sufficient and meaningful data are available, a well-reasoned, thorough valuation will consider each of the three generally accepted business valuation approaches:

1. The income approach
2. The market approach
3. The asset-based approach

Within each of these approaches, there are multiple valuation methods that may be applied. Market approach valuation methods that may be applied include (1) the GPTC method and (2) the guideline merged and acquired company method.

The valuation analyst may apply one or more of these valuation approaches—and one or more methods within each selected valuation approach. The value indications from these valuation approaches and methods are often weighted to arrive at a value conclusion.

This discussion focuses on the application of the market approach GPTC method.

The Market Approach GPTC Method

Actual market transaction data can be used to present a compelling indication of the value of a company in the market approach GPTC method.

Revenue Ruling 59-60 states that a fundamental consideration in the valuation of a company is "the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter."[1]

As a reliable indication of the fair market value of a company, an analyst may look for market transaction data of ownership interests exchanged in an open and unrestricted market by buyers and sellers that are well-informed and are not under compulsion to buy or sell.

Such data is available to the analyst from the daily transactions in publicly traded companies. In the United States, there are stringent disclosure laws that mandate publicly traded companies to provide relevant data to investors—thus, buyers and sellers have the capacity (and motivation) to be well-informed.

In the GPTC method, an analyst can use securities pricing and financial data related to the GPTCs to calculate the market value of invested capital of the GPTCs.

The analyst can then develop valuation pricing multiples by dividing the market value of invested capital by the underlying financial fundamentals.

Commonly used financial fundamentals include the following:

1. Net sales
2. Earnings before interest and taxes (EBIT)
3. Earnings before interest, taxes, depreciation, and amortization (EBITDA)

In order to estimate the market value of invested capital of a company, an analyst can apply the

Exhibit 1
Resources Available for Market Data

A number of credible and useful resources are available to aid the analyst in finding GPTCs. Particularly in the valuation of atypical companies, the analyst should apply an extensive search of multiple databases to select GPTCs with a sufficient degree of comparability.

Databases available to the analyst include the following.[a]

Bloomberg

Bloomberg is a fully searchable online database that provides financial information on nearly all active and inactive U.S. publicly traded companies and active and inactive international companies. Companies may be searched by industry sectors or by Standard Industrial Classification (SIC) codes. Detailed financial information is available. The information is updated frequently. More information is available at www.bloomberg.com/professional/.

MergentOnline

MergentOnline is a fully searchable online database that provides financial information on over 15,000 active and inactive U.S. publicly traded companies and approximately 20,000 active and inactive international companies. Companies are listed by SIC codes and by North American Industry Classification System (NAICS) codes. More information is available at www.mergentonline.com.

S&P Capital IQ

S&P Capital IQ contains detailed financial and textual information on approximately 79,000 publicly traded companies (both domestic and foreign). The information is derived from documents filed with the Securities and Exchange Commission and similar global stock regulators (as well as proprietary research). The database may be searched by SIC code or by Standard & Poor's industry classifications. Detailed financial information is available. The information is updated frequently. More information is available at www.capitaliq.com.

Thomson ONE

Thomson ONE is a fully searchable online database that provides financial information on approximately 52,000 public companies and over one million private companies. Companies may be searched by Global Industry Classification Standard (GICS) codes or SIC codes. Detailed financial information is available. The information is updated frequently. More information is available at http://thomsonreuters.com.

FactSet

This database provides an equity screener with capabilities to screen using numerous criteria, including industry; business description; financial data such as revenue, EBITDA, or assets; geographic location; and closing price, to name a few. The database contains information on over 73,000 companies worldwide. Over 2,000 unique financial data items are provided. More information is available at www.factset.com.

Pitchbook/BVR Guideline Public Company Comps Tool

This database includes information on all publicly traded U.S. companies. Users can screen using numerous criteria including industry; business description; financial data such as revenue, EBITDA, or assets; geographic location; and closing price, to name a few. More information is available at www.bvmarketdata.com.

Footnote:

[a] Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation* (New York: American Institute of Certified Public Accountants, 2013), 137–138.

valuation pricing multiples derived from similar companies to the respective underlying financial fundamentals of the company.

A number of credible and useful resources are available to aid the analyst in finding GPTCs. Particularly in the valuation of atypical companies, the analyst should apply an extensive search of multiple databases to select GPTCs with a sufficient degree of comparability.

The accompanying Exhibit 1 presents descriptions of several databases that are relevant to the application of the GPTC valuation method.

Comparability of the GPTCs

The GPTC method relies on consideration of the financial fundamentals of publicly traded securities and the financial fundamentals of the subject company. It is imperative to the credibility of the analysis that the GPTCs selected in the analysis have similar characteristics to the subject company.

The underlying characteristics that should be present in a guideline company are summarized in the following quote: "Do the underlying economics driving this comparable company match those that drive our company?"[2]

While the selected GPTCs do not have to be a precise match to the subject company, the characteristics of a guideline company should be such that "the microeconomic factors that drive the guideline companies should be sufficiently similar to the microeconomic factors that drive the subject company."[3]

Frank M. Burke Jr. succinctly summarizes this pursuit of reasonable comparability in *Valuation and Valuation Planning for Closely Held Businesses*, "Obviously finding a business exactly the same as the enterprise to be valued is an impossibility. The standard sought is usually one of reasonable and justifiable similarity."[4]

There are rarely (if ever) any companies that are exactly comparable to the company being valued. Comparison to GPTCs is a subjective exercise that results in a spectrum of comparability, with some GPTCs being more comparable and others being less comparable to the subject company.

It should be noted that the GPTCs are *guideline* publicly traded companies and should accordingly be used as a source of pricing guidance to indicate the value of a company.

If an analyst relies on GPTCs that are not sufficiently comparable to the company being valued, the analyst may overvalue or undervalue a company. The market value of invested capital or the financial fundamentals of the GPTCs may be affected by different trends than the company being valued.

For example, the market value of invested capital of the GPTCs may be positively affected by investor speculation of industry growth.

If the company being valued is in a different industry and is not anticipated to have strong growth, the use of pricing multiples from the set of GPTCs with expectations of growth may overvalue the company.

Consider the hypothetical valuation of Eyeball Design. As previously discussed, Eyeball Design manufactures prosthetic eyeballs that do not have any function beyond aesthetics and do not enable vision in anyway. An outside manufacturer provides Eyeball Design with ceramic shells based on detailed specifications and measurements of the customer.

Eyeball Design employees then hand-paint these ceramic shells using unsophisticated equipment, completing the manufacturing process of prosthetic eyeballs.

Suppose the analyst selects Second Sight Medical Products, Inc., as one of the GPTCs. Second Sight Medical Products, Inc. ("Second Sight") manufactures implantable prosthetic devices to restore functional vision to blind patients. These prosthetic devices use an implantable neurostimulation device that uses electrical stimulation of the retina to replace the function of defunct photoreceptors in retinitis pigmentosa patients.

While both Second Sight and Eyeball Design manufacture prosthetic eyeballs, these companies are fundamentally different. The functionality of the prosthetic eyeballs manufactured by Second Sight offers tremendous value to a patient compared to the nonfunctional prosthetic eyeballs offered by Eyeball Design.

Additionally, the level of sophistication of the manufacturing processes is very different between these two companies.

These substantial fundamental differences may cause the value indication from the GPTC method to overvalue or undervalue Eyeball Design by applying market transaction pricing data that assigns value to factors that may not be present in Eyeball Design.

Comparability Factors Listed by the Tax Court

In order to maintain the integrity of a valuation prepared for consideration by the Tax Court, there are a number of factors an analyst should consider when selecting GPTCs.

In two different cases, the Tax Court presented a list of factors to consider when determining comparability. These factors can be considered by analysts when selecting GPTCs.

In *Talichet v. Commissioner*, the Tax Court described six "guideposts in determining comparability":[5]

1. Capital structure
2. Credit status
3. Depth of management
4. Personnel experience
5. Nature of competition
6. Maturity of the business

In the *Estate of Victor P. Clarke*, the Tax Court listed the following factors relevant to determining the comparability of the company being valued and the GPTCs:[6]

1. Products
2. Markets
3. Management
4. Earnings
5. Dividend-paying capacity
6. Book value
7. Position of company in industry

In addition to the factors presented above, there are a number of additional comparability factors an analyst should consider when selecting GPTCs for the valuation of atypical companies.

Analysts should carefully analyze the financial statements of the subject company and the GPTCs, noting the similarities or differences in liquidity, leverage, activity, anticipated growth, and profitability.

Analysts should also consider historical trends in revenue, expenses, and profitability.

Scrutiny of the Comparability of the GPTCs

The analyst should proceed with caution when applying the GPTC method for the valuation of an atypical company for gift and estate tax reporting purposes.

Valuations of atypical companies for gift and estate tax planning and compliance purposes may encounter scrutiny by the Tax Court regarding the comparability of the GPTCs.

While the Internal Revenue Service is "one of the strongest proponents of the guideline publicly traded company method,"[7] there are two Tax Court cases discussed below in which the comparability of the GPTCs to the companies being valued was faulted.

While the companies discussed in these two Tax Court cases are not atypical, the level of scrutiny applied to the GPTCs in these valuations provides insight into the degree of comparability accepted by the Tax Court.

In the Estate of Heck v. Commissioner,[8] the estate of the decedent included 630 shares of the outstanding stock of F. Korbel & Bros., Inc. (Korbel), a producer of champagne. The valuation expert witness for the respondent relied on two GPTCs:

1. Robert Mondavi Corp. (Mondavi)
2. Canandaigua Wine Co. (Canandaigua)

At the valuation date, Mondavi marketed premium wine, while Canandaigua offered a wider variety of products including table wines, dessert wines, sparkling wines, imported beer, and distilled spirits.

The sale of champagne peaks around holidays, demonstrating more seasonality than other alcoholic beverages.

The Tax Court noted that it had previously relied on as few as two GPTCs in its judicial decisions. However, the underlying differences between the GPTCs and Korbel, in conjunction with the selection of only two GPTCs, did not yield a credible value indication in this case.

In the *Estate of Louise Paxton Gallagher v. Commissioner*, the decedent owned 3,970 membership units in Paxton Media Group, LLC (PMG).[9]

As of the valuation date, PMG published 28 daily newspapers, 13 paid weekly publications, and owned and operated a television station.

The valuation expert for the respondent selected four GPTCs, three of which heavily integrated Internet news into their business models, while PMG did not offer any Internet news services.

Additionally, two of the selected GPTCs supplemented their newspapers with a wide variety of classified, specialty, shopper, and niche publications.

The Tax Court determined that the four GPTCs selected by the expert witness for the respondent were not sufficiently comparable to warrant application of the guideline publicly traded company method, citing differences in products as well as size and growth rates of revenue and EBITDA.

A recent court case from the Court of Chancery of Delaware, *In re ISN Software Corp.*,[10] illustrates the particular challenges of selecting GPTCs for the valuation of an atypical company.

ISN Software Corp. (ISN) provides a subscription-based online contractor database designed to help users meet governmental and internal recordkeeping and compliance requirements.

The Court of Chancery disregarded the GPTC method considered by the valuation experts and, instead, relied exclusively on the income approach and the discounted cash flow (DCF) method.

The Chancery Court noted, "In this case, where ISN has no public competitors, and where the Company's alleged industry includes various and divergent software platforms, I find the GPC method less reliable than a DCF to determine ISN's fair value."[11]

Consideration of Related Industries for the Valuation of Atypical Companies

For some companies, there may be very few GPTCs with sufficiently comparable operations. Given the absence of publicly traded companies with similar products and financial characteristics, an analyst may find the selection of GPTCs with a reasonable degree of comparability to an atypical company to be very difficult.

Analysts may be particularly challenged to find sufficiently comparable GPTCs in emerging industries and niche markets.

If the products of the subject company are in an emerging industry, competitors may have yet to develop a comparable product. Regarding niche markets, there may be a dearth of GPTCs offering a similar product. When GPTCs that offer a similar product are not available, the analyst may consider GPTCs from related industries.

When considering GPTCs from related industries, the analyst should consider the degree of comparability implied in Revenue Ruling 59-60, which states "the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the **same or similar**" [emphasis added].[12]

As discussed in *Valuing a Business*, "this phrase [the same or similar] gives the analyst latitude to exercise reasonable judgement in selecting companies from related industries if unable to find guideline companies in the subject company's industry group or companies with adequate trading volume."[13]

If the analyst chooses to select GPTCs from a related industry, the analyst should consider the investment risk and return factors of both the GPTCs and the company being valued regarding the previous factors considered by the court. These factors include the following:

1. The markets in which the products are sold
2. The nature of competition
3. The book value and earnings of the GPTCs

An example of consideration of GPTCs from related industries in the GPTC method is in the valuation of E. & J. Gallo Winery (Gallo) in the *Estate of Mark Gallo*.[14]

Gallo was the largest producer of wine in the United States, and, as of the valuation date, there was only one publicly traded wine company stock. The valuation expert witnesses for the petitioner therefore expanded their GPTC selection to include distillers, brewers, soft drink bottlers, and food companies that were subject to seasonal crop conditions and competitive market conditions.

The selection of GPTCs from related industries was accepted by the Tax Court in the *Estate of Mark Gallo*. The Tax Court concluded that the "petitioner's experts acted reasonably in selecting comparable companies."

Both *Estate of Mark Gallo* and *Estate of Heck v. Commissioner* previously discussed involve the valuation of an alcoholic beverage producer, with GPTC selection from related industries.

There are two important differences that the Tax Court considered in rejecting the validity of the GPTCs in the *Estate of Heck v. Commissioner* and affirming the GPTC selection in the *Estate of Mark Gallo*.

First, in the *Estate of Heck v. Commissioner*, the GPTCs were selected from an industry with significant underlying differences (sale of champagne demonstrates much more seasonality than other alcoholic beverages).

Second, only two GPTCs were considered in the *Estate of Heck v. Commissioner*, while in the *Estate of Mark Gallo*, one of the petitioner's expert witnesses relied on 10 GPTCs.

The Quantity of the GPTCs

As shown in the contrasting outcomes of GPTC selection from related industries in the *Estate of Mark Gallo* and the *Estate of Heck v. Commissioner*, the quantity of GPTCs may have a significant effect on the reliability of the value indication based on the GPTC method.

In the valuation of atypical companies, analysts will likely be challenged to find a meaningful number of GPTCs and may question if the quantity of GPTCs is sufficient to arrive at a reasonable value indication.

The required quantity of GPTCs is generally inversely related to the degree of comparability of the GPTCs to the company being valued. That is, the more comparable the GPTCs are to the company being valued, the fewer GPTCs are required to arrive at a reasonable value conclusion.

This relationship was noted in the *Estate of Heck v. Commissioner*, in which the Tax Court stated, "as similarity to the company to be valued decreases, the number of required comparables increases in order to minimize the risk that the results will be distorted by attributes unique to each of the guideline companies."[15]

The analyst may find that relying on as few as two or three GPTCs with a high degree of comparability is sufficient for a reasonable value indication.

Alternatively, while valuing an atypical company, an analyst may find a group of GPTCs with a low but acceptable degree of comparability and one or a few GPTCs with a higher degree of comparability to the company being valued.

In such a case, it may be appropriate to tabulate the entire group of GPTCs to illustrate general market trends, but to assign a higher weighting to the more comparable GPTCs to favor more comparable pricing multiples.

Absence of GPTCs with Sufficient Comparability

If the analyst determines that there are no identified GPTCs with sufficient comparability to the subject company after consideration of the previously outlined economic factors that drive operations and profitability, the GPTC method may not be appropriate as a value indication.

If the analyst concludes that the GPTC method does not provide a meaningful value indication, it may be judicious for the analyst to document within the valuation report:

1. the procedures applied to identify potential GPTCs and
2. why the GPTC method was not relied on.

Weighting of the Market Approach GPTC Method

When selecting the weighting of the guideline publicly traded company method, the analyst should consider the quality of the data supporting this value indication.

If the GPTCs in the GPTC method have a low degree of comparability to the company being valued, then the analyst may consider applying more weight to value indications from other valuation approaches, if those value indications are more reasonable.

If the GPTCs selected do not lend a credible value conclusion due to a lack of comparability of the GPTCs to the company being valued, then the analyst may consider giving no weight to the GPTC method value indication. Alternatively, the analyst may present this GPTC value indication solely as an indicator of reasonability.

Conclusion

Analysts often value a wide variety of companies for gift and estate tax planning and compliance purposes, which may include atypical companies with unusual products or services that have very few direct competitors.

The analyst may encounter difficulty selecting GPTCs in the valuation of atypical companies when applying the GPTC method of the market approach valuation method. The analyst should judiciously select GPTCs that bear a reasonable level of comparability to the company being valued regarding the economic factors that drive operations and profitability. The analyst should also consider the permitted degree of comparability implied in Revenue Ruling 59-60 of "same or similar."

Notes:

1. Rev. Rul. 59-60, 1959-1 CB 237.
2. Daniel W. Bielinksi, "The Comparable-Company Approach: Measuring the True Value of Privately Held Firms," *Corporate Cashflow Magazine* (October 1990): 65–66.
3. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies,* 5th ed. (New York: McGraw-Hill, 2008), 270.
4. Frank M. Burke Jr., *Valuation and Valuation Planning for Closely Held Businesses* (Englewood Cliffs, NJ: Prentice-Hall, 1981), 49.
5. Talichet v. Commissioner, 33 T.C.M. 1133 (1974).
6. Estate of Victor P. Clarke, 35 T.C.M. 1482 (1976).
7. Pratt, *Valuing a Business*, 270.
8. Estate of Heck v. Commissioner, T.C. Memo 2002-34 (Feb. 5, 2002).
9. Estate of Gallagher v. Commissioner, T.C. Memo 2011-148 (June 28, 2011).
10. In re ISN Software Corp., CA No. 8388-VCG, 2016 WL 4275388, at 4 (Del. Ch. Aug. 22, 2016).
11. Ibid.
12. Rev. Rul. 59-60, 1959-1 CB 237.
13. Pratt, *Valuing a Business*, 272.
14. Estate of Mark S. Gallo, 50 T.C.M. 470 (1985).
15. Estate of Heck v. Commissioner at 9.

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