**The Public Be Damned**

One of the three approaches to valuing a business is the market approach – and within that approach, there are a few methods. This article addresses one of those methods – the Guideline Company method. In the past this was also called the Comparable Company method – but the favored terminology has changed from Comparable to Guideline. This method of valuation, this part of the market approach, involves the use of public companies as a basis for developing one or more points of comparison to the subject entity for purposes of valuation.

Briefly, and to kind of oversimplify, for purposes of this article, there are two types of companies – privately held and publicly held. The privately held companies take the form of corporations, partnerships, sole proprietorships, etc. The critical issue here is that they are privately owned – they are not traded on any kind of open public market. On the other hand, there are the publicly owned companies – for our purposes those would be the ones traded on some form of open market, whether that be the New York Stock Exchange, the NASDQ, or any other public trading forum. It is this group of publicly traded companies that are relevant to this article.

Many valuation experts consider the market approach to be an excellent one – it allows us to get away from the theoretical income approach, and instead determine value based on comparisons to actual transactions. After all, we are letting the market dictate value – and in theory what could be better and more reliable than that? The problem is that there are very few situations where the company being valued is the same as, virtually identical to, several, even one, publicly traded company. That is, unlike a 4-bedroom colonial on a 1 acre lot, every business is truly different. Thus, using the market approach mandates making subjective determinations as to the degree of comparability, and additional fine tuning may be necessary in order to be satisfied that indeed you can use the market approach for valuing the company that is at issue in the current matter.

Some of the issues that we experience when trying to use guideline companies (trying to compare the subject company to publicly traded companies), include:

- Size – almost without exception, the publicly traded companies are typically larger, sometimes much larger, than the subject being valued.

- Product diversification – often, publicly traded companies have a greater product diversity than the company being valued. For instance, perhaps both of them sell widgets – but the publicly traded companies sell 10 other things besides widgets, and maybe the widgets are only 20% of what they sell. Are these companies still guideline companies for valuation purposes?

- Degree of comparability – this entails a multitude of issues, including those discussed at other bullet points here. That is, just how comparable is the subject company to what the expert has determined to be guideline (comparable) companies?

- Depth of management – publicly traded companies tend to have a greater depth of management than the subject being valued. There are some exceptions, and sometimes a larger privately held company has a good depth of management; and sometimes some of the smaller publicly traded companies have a fairly thin management.

- Balance sheet strength – this one can be all over the place, but many times the publicly traded companies have significant equity, a solid balance sheet. By no means is that always the case – but can the subject entities balance sheet be reasonably compared to the so-called guideline companies? Keep in mind there are many cases where it can be compared – and in some cases it is in better shape than various of the publicly traded companies.

The above are some of the issues routinely experienced by the valuation expert in trying to arrive at guideline companies that can be used for valuation purposes. These issues do not mean that the guideline company method should not be used – only that it must be used carefully and selectively. Let us briefly address some of these concerns and how they relate to what we need to do in valuation.

For instance, does it matter that the company being valued has sales of $50 million; whereas the guideline companies have sales of say between $300 million and $5 billion? Arguments can certainly be made both in favor and against the use of such comparable/guideline companies. Generally speaking, that type of size differential is not fatal to the use of such companies for comparison purposes. On the other hand, if the subject entity is a manufacturer of plastics, and the chosen guideline companies are a mélange of various types of manufacturers, is the mere fact that the guideline companies are manufacturers (as is the subject company) enough to use them – or need they also be plastics manufacturers? I venture to say that most valuation experts will tell you that it is important that the guideline companies also be plastic manufacturers – simply they being manufacturers is insufficient for comparability purposes.

Or, with the subject entity being a plastics manufacturer, would it be acceptable for the guideline companies to simply be in the plastics field? For instance, wholesalers and distributors of raw plastic material, wholesalers and distributors of finished plastic material, retailers of say plastic bags, etc. Is the common connection to plastic sufficient to make these guideline companies? Again, most experts will advise that there needs to be something more in common with the guideline companies than simply that they are all in this broad category of something to do with plastic.

Assuming that the expert has succeeded in arriving at several companies that are truly comparable, appropriate to be called guideline companies, and further that the expert has determined which factor(s) of value to use (say a multiple of earnings, multiple of sales, multiple of book, etc.) – there remains at least one more significant step that needs to be considered. That is – to what extent, if any, need these factors, these multiples, be adjusted to reflect the relatively weaker (though it is possible it could be relatively stronger), and certainly less marketable position of the privately held company being valued as in contrast to the publicly held guideline companies. By way of example, if the expert determined that the best benchmarks for value were the price to earnings ratio and the price to sales ratio, and if those were say 15 to 1 and 50% respectively, the expert then needs to decide whether there should be any adjustments to those multiples, and if so to what extent. For instance, should the price to earnings ratio be reduced by ⅓ - using only a 10 multiple of earnings in the valuation of the privately held company? Similarly, should the multiple of sales be reduced by perhaps 1/5 , thus resulting in a measure of value for the privately held company of 40% of sales? These type of subjective qualitative adjustments need to be considered and then, as appropriate, applied by the expert.

Thus, while in theory the use of publicly traded companies as a comparison for determining the value of a privately held company can be an excellent method of value, in theory perhaps superior to all others, it is also a method that can be difficult to use because of the wide variety of issues, not the least of which is finding companies that are truly comparable.