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AMERICAN SOCIETY OF APPRAISERS Business Valuation Committee Special Topics Paper #1 Use of Offers as Indications of Value in the Market Approach[a]

The market approach can often provide the best indication of the value of a business or an interest therein, because arm's length transactions in, or offers for, a business ownership interest, security, or intangible asset may provide objective, empirical data that can be used in the valuation.

Market Approach: General Background

The market approach can often provide the best indication of the value of a business or an interest therein because arm's length transactions in, or offers for, a business ownership interest, security, or intangible asset may provide objective, empirical data that can be used in the valuation.

Valuation methods under the market approach include the guideline public company method,[1] guideline transactions method,[2] and consideration of formal offers for the subject ownership interest.

While this white paper has been prepared with respect to "fair market value" in the context of business valuation, it also considered financial accounting standards, which prefer the use of the market approach in "fair value" measurement, taking into consideration "market participant" assumptions and market conditions at the valuation date (i.e., the measurement date). In this context, *observable* market-based measures are viewed as being less subjective than *unobservable* inputs. For example, the central component of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures* (formerly known as FASB Statement No. 157, *Fair Value Measurement for Financial Reporting*)[3] is the fair value "hierarchy." Within this hierarchy, the market approach represents the highest level, with priority being assigned to (unadjusted) quoted prices in active markets for identical assets or liabilities.

International Financial Reporting Standard 13, *Fair Value Measurement,* also contains a hierarchy, which categorizes the inputs used in applying valuation techniques into three levels, the two highest levels being the market approach.

This white paper also considers the views of other professional organizations and societies.

Offers as Indicators of Value

The *International Valuation Standards* state the following:

> C15. The *market approach* compares the subject business to similar businesses, business ownership interests and securities that have been exchanged in the market and any relevant transactions of shares in the same business. Prior transactions **or offers** for any component of the business may be also indicative of value. (emphasis added)
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> C16. The three most common sources of data used in the market approach are public stock markets in which ownership interests of similar businesses are traded, the acquisition market in which entire businesses are bought and

[a]This paper is intended to represent the recommended approach according to the Business Valuation Committee of American Society of Appraisers. However, it does not constitute a standard and is not authoritative. Facts and circumstances could require the use of further professional judgment and a different approach.

[1]Statements on ASA Business Valuation Standards ("SBVS")-1, *Guideline Public Company Method*.

[2]SBVS-2, *Guideline Transactions Method*.

[3]FASB ASC 820, *Fair Value Measurements and Disclosures*.

> sold, and prior transactions in shares ***or offers for the ownership of the subject business.*** (emphasis added)

The market approach, based on offers for an ownership interest in a business, could provide an indication of the business interest's fair market value.

Indicative offers

Indicative offers recently received from a third party for the underlying business might provide a good indication of fair market value. This could apply to offers for part or the entire underlying business.

However, it may be that "indicative offers" could be "insufficiently meaningful to be used in isolation," because the offers might be made based on insufficient detailed information to be "properly valid." There can be a critical distinction between (a) "indicative offers" and (b) "properly valid" offers ("formal offers") when applying the market approach to valuation.

In a structured sales process, an indicative offer is made at an early stage (generally taking the form of a term sheet or a nonbinding proposal), which provides an indication, or preliminary indication, of how much a potential buyer is willing to pay for an equity interest in a company. The price is based solely on the information (e.g., historical financial results, projections, opportunities) that was provided by management in the seller's disclosures. Such disclosures, such as a confidential information memorandum, are designed to attract potential buyers and provide sufficient information to allow a potential buyer to estimate a value for the seller company. In estimating a value, the potential buyer will also consider publicly available information, and potential, or perceived, post-acquisition synergies that might be achieved.

An indicative offer lists the preconditions that the potential buyer requires before engaging in further negotiations and making a binding proposal. Examples of preconditions include, but are not limited to, due diligence; exclusivity terms; confirmation of statutory, internal, or other necessary approvals; and drafting of a sale-purchase agreement. Once these conditions are met, the potential buyer is in a position to make a formal offer that, if accepted by the seller, becomes binding.

An indicative offer does not give rise to any legal rights or obligations between the parties and does not constitute a promise to engage in further negotiations and commit to a transaction; rather, it helps the seller identify the potential buyers for its business and then select those with whom the seller is willing to enter into serious discussions.

Formal offers

Unlike indicative offers, formal offers are based on sufficiently detailed information gathered as part of the due diligence process and an understanding of all of the relevant facts that are deemed to impact the acquirer's decision to buy and the price at which the acquirer is willing to close the deal.

Therefore, for formal offers to provide probative evidence of value under the market approach, the offers must be firm, be at arm's length, contain sufficient detail of the deal terms to be able to estimate the cash equivalent value, and be from a potential purchaser who has the financial ability to consummate the offer, after having gathered sufficient information and a reasonable knowledge of the relevant facts. If these requirements are met, then the acquirer's offer could be considered in manner similar to a past transaction for purposes of arriving at an indication of value using the market approach.

If, however, the offer did not result in a consummated transaction, the weight that is accorded to the value indicated by the offer might be reduced. In some cases, a post-valuation date, consummated, arm's-length transaction can assist the business appraiser in supporting or refuting a value conclusion that was based on an offer that existed, but not yet acted upon, as of the valuation date.

Factors considered in analyzing offers

In analyzing an offer for purposes of determining the weight to which it be accorded, the following factors, among others, are generally considered:

- Whether the parties were dealing at arm's length
- Whether the parties were sophisticated and knowledgeable
- Whether the parties acted rationally
- Presence of representations and warranties
- The forms and terms of payment, including the amount of cash paid at closing
- The salient provisions of a management contract, if any, and the estimated duration thereof (including salary, performance incentives, and employment benefits)
- Whether the offer was subject to financing, regulatory approval, or other conditions
- Whether there would be any significant or unusual representations and warranties that the seller was asked to agree
- Significant terms of a noncompetition and/or nonsolicitation agreement that the seller and possibly key employees was/were asked to execute
- Amount of the purchaser's deposit and the circumstances under which the purchaser would be able to recover it

- The nature and the amount of security offered by the purchaser for the portion of the purchase price not yet received by the seller at the closing of the transaction
- Whether there were any potential grounds for last-minute renegotiation
- Whether the offer emanated from a source having the financial ability to consummate the offer and close the transaction
- Whether the willing and uncompelled market participants were informed and possessed reasonable knowledge and understanding of all the relevant facts, including the risk of the investment and how that risk was priced in the acquirer's offer
- Whether the offer provided sufficient details of the proposed terms thereof for a proper estimate to be made of the cash equivalent value
- Whether the offer was bona fide and made in a transparent environment.

In summary, the seller and its advisors would carefully weigh the risks and rewards associated with the various forms and terms of payment relating to the offer. Such consideration would contemplate the nature of the business (e.g., highly cyclical or relatively stable), the type of acquirer, and the payment or transaction terms of other mergers and acquisitions known to have occurred in the industry. The seller would also consider the various forms and terms of payment in relation to its financial position and its tolerance. In essence, the potential reward for accepting noncash consideration should compensate the seller for the potential risk of not realizing the contingent and/or deferred amounts.

Also, in considering offers when applying the market approach to valuation, the business appraiser should be mindful of the environment in which the sale process had been conducted during the period of exposure. In this regard, the business appraiser should ascertain whether the sale process was robust and conducted in an orderly, rather than a forced or distressed, manner.

When performing a comparative assessment of offers received, the cash equivalent value of each offer should be determined. This is accomplished by estimating the risk-adjusted present value of any component of the purchase price not received in the form of cash (money or money's worth) at closing.

In considering either an indicative offer or a formal offer, an analysis must also be made of the market participants to assess whether they (1) were under any compulsion to act, (2) were fully informed of all relevant facts, (3) had the financial and legal capacity to transact, and (4) were acting at arm's length.

Formal offers based on market data that reflect market participant assumptions—in particular, assumptions about the risk of the investment—represent Level 1 inputs in the value hierarchy (if the formal offer was for the same business or business interest) or Level 2 (if the formal offer was for a substantially similar, "comparable" business or business interest. When using Level 2 or Level 3 inputs, the business appraiser will typically incorporate a risk premium adjustment to reflect the additional return that market participants would demand as compensation for the uncertainty inherent in the financial projections. This adjustment could be significant to the entire measurement, because it is based on unobservable inputs, which generally provide a less meaningful result.

Conclusion

The market approach, using formal offers for an ownership Interest in a business, is generally superior to the application of the discounted cash flow (DCF) method. The market data derived from formal offers reflect the real-world judgment of informed and uncompelled acquirers who assessed the reasonable occurrence and related effects of the noncontrollable, external factors and related business risks in their determination of an offer price. The DCF method is subject to a high degree of subjectivity and judgment, being that it is dependent on various components that are subject to the business appraiser's judgement. These components include (but are not limited to) the underlying projections and the present value discount rate, both of which comprise the framework of such method. The DCF method involves using unobservable inputs, whereas the market approach is based on observable inputs, which rank higher in priority in the fair value measurement hierarchy.

Generally, it would also be reasonable for the business appraiser to assume that prudent, informed, and uncompelled market participants, in preparing an offer price, would have considered and analyzed the materials provided to them (including DCF analyses) in the context of the various noncontrollable risks that could potentially affect the business's future operations.

If a formal offer is used within a market approach analysis, it would generally be the low end of the fair market value range, because the notional purchaser would be prepared to transact at that price.

In conclusion, offers that would be considered in adopting the market approach must be properly analyzed with respect to the types of factors enumerated above and be both meaningful and robust.