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Understanding Business Valuation

A Practical Guide to Valuing Small to Medium Sized Businesses

Fifth Edition | **Gary R. Trugman,** CPA/ABV, MCBA, ASA, MVS

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Chapter 5

Data Gathering

Learning Objectives

In this chapter, I will attempt to do the following:

- Explain which items have an impact on value
- Discuss internal information sources for gathering data
- Discuss external information sources for gathering data
- Inform you about some types of data sources

Let me caution you that the information contained in this chapter changes faster than I can write about it. As far as I know, this stuff was current when it was written. I will apologize in advance if you go to look for something and you can no longer find it, or it has significantly changed. That is beyond even my control. With that said, let's get started.

Introduction

This chapter includes a discussion of internal and external sources of information that the valuation analyst will gather. Numerous references are provided about where you can locate information. This chapter lists all types of sites on the Internet for doing the required research.

What Items Affect Value?

An important part of the valuation assignment is to determine the proper amount of information necessary to do the job competently. The information-gathering part of the assignment will generally require the valuation analyst to demonstrate knowledge about the subject company and the factors affecting its value. Both internal and external factors affect the value of a business or business interest. During the information-gathering step of the valuation process, a variety of information will be requested by the valuation analyst.

Internal Information

Internal information obtained during the data-gathering process will consist of both nonfinancial and financial information. Each type of information will play an important role in the valuation process. In some instances, the valuation analyst should consider the nonfinancial information to be as important as, or more important than, the financial information. Too often, a telephone call comes in from the attorney who states, "I got you 5 years of tax returns and financial statements. Can you give me the value?" After you stop laughing, the attorney should be told, "Of course I can give you the value, but not until I get the other 47 things that are on my checklist." Although not every job will require 47 other items, there will always be more information needed.

Nonfinancial Information

Nonfinancial information may be gathered through a document request, a management interview, or through independent research by the valuation analyst. Some of the more important information that the valuation analyst should gather includes the following:

- Legal documents
- Products and services
- Markets and marketing

- Physical facilities
- Equipment
- Personnel
- Other stuff

Legal Documents

Some of the first pieces of information that an analyst needs in order to begin the valuation process include the various legal documents that determine how a business is organized and governed, what restrictions are placed on investors, and what the company can and cannot do. Some of the legal documents that are commonly requested include the following (this is not an all-encompassing list):

- Articles of incorporation and formation
- Shareholder, operating, and partnership agreements
- Bylaws
- Franchise agreements
- Management services agreements
- Employment agreements
- Non-competition agreements
- Buy-sell agreements

The form of ownership is an important component of the business valuation process because during the valuation process, the valuation analyst will have to consider the comparability of information obtained about other companies (known as *guideline companies* or, previously, *comparables*) or industry composite data. Good comparability must be maintained to ensure the quality of the data that will be used for comparison purposes during the valuation process.

Another reason to know the form of organization is that the legal rights applicable to the interest being valued must be considered by the valuation analyst for the determination of possible restrictions that apply to the subject company or the owners. For example, a minority (non-controlling) owner in a corporation normally does not have the ability to force the liquidation of a corporation. Therefore, that minority interest will most likely be valued using an approach that is not based on the value of the assets, which would have to be sold to realize their value. On the other hand, a minority interest in a general partnership is controlled by the Uniform Partnership Act, which states that any partner who withdraws from the partnership can cause a winding down and dissolution of the partnership, thus, providing him or her with the ability to obtain the proportionate share of the proceeds from the partnership's dissolution.

The ownership of the business is also important because the valuation analyst will need to assess considerations such as control, minority, or swing vote issues. This can be illustrated by considering the value of a 2 percent interest in a corporation. If there are 50 stockholders with a 2 percent interest in the company, each 2 percent interest would probably be worth very little. However, what if the 2 percent interest were to be valued when the other stockholders each own 49 percent? The 2 percent interest could have swing value, which could be very valuable to one of the other stockholders because it would give one of them control of the company. This could cause a premium to be associated with the 2 percent interest.

Let me give you another example of a real-life situation in which the rights of ownership can affect value. Years ago, I had the occasion to value a 1.6 percent beneficial interest in a trust for the IRS. Well, in that same job, the trust owned a 90 percent interest in a closely held investment holding company that owned, among other things, a 47.3 percent block of a thinly traded public company (*thinly traded* means that there are not too many shares trading on any given day). Because the stock was thinly traded, the valuation analyst who represented the taxpayer deducted a blockage discount. (This will be discussed in more detail in chapter 15, but, in the meantime, a blockage discount is a reduction in value because it will take a long time to sell.) When I first received the assignment, I asked the attorneys for the IRS for a copy of the bylaws of the public corporation so that I could see what rights, if any, were spelled out in this legal document. I was told that they would get the document for me, but until they did, because the company was incorporated in the state of Delaware, I should assume that a simple majority constitutes a controlling interest. By the way, the second largest block of stock (8 percent) was owned by the trustee of the trust that I was valuing an interest in. Got it so far? This is the type of assignment that you either live for or die doing. Anyway, because the 47.3 percent interest in this public company had effective control (all they really had to do was show up to a stockholders meeting and they would carry the vote), and because the trustee owned the next largest block of stock, I took the position that the prudent thing for the board of directors to do was to find someone to purchase the company because it was undervalued according to my intrinsic analysis.

To make a long story short, I added a control premium to the publicly traded value instead of taking a blockage discount. To put things into perspective, the difference in value between my valuation and the other valuation analyst for the publicly traded stock alone was $150 million. So where am I going with this story? A week before I was getting ready to testify in tax court, I received a phone call from the attorney for the IRS. He said, "I finally tracked down those bylaws that you asked me for (3 months ago!). Let me read something to you and see if it changes anything that you have done." I knew I was in trouble. The bylaws were from 1896 and had not been updated. They required an 80 percent supermajority to sell, liquidate, or merge the company. I said, "Settle the case." The rights of the shareholders made a difference of about $150 million in this case. This will make more sense to you after reading chapters 14 and 15, but this was the logical place for this story, and it is my book, so I put it here.

Franchise agreements often dictate what the company must do as a part of its normal operations. Car dealerships are often required to update the appearance of their showrooms as the manufacturer changes its logos, branding, and image. This would necessitate occasional capital investments to update the facility, which would need to be accounted for in a forecast of net cash flow. McDonald's franchises had to update their facilities to put in a McCafé® when the franchisor decided to compete with its own coffee bar. In other franchise agreements, an analyst might come across a provision like the one shown in exhibit 5.1.

EXHIBIT 5.1 Our Right to Purchase Business

(1) Exercise of Option. Upon termination or expiration of this Agreement in accordance with its terms and conditions, we have the option, exercisable by giving written notice thereof to you (by the later of (a) sixty (60) days from the date of such termination or expiration or (b) seven (7) days after determination of the purchase price), to purchase the BUSINESS from you, including the leasehold rights to the Location, free and clear of all liens, restrictions or encumbrances. (The date on which we notify you whether or not we are exercising our option is referred to in this Agreement as the "Notification Date.") We have the unrestricted right to assign this option to purchase the BUSINESS. We will be entitled to all customary warranties and representations in connection with our asset purchase, including, without limitation, representations and warranties as to ownership and condition of and title to assets; liens and encumbrances on assets; validity of contracts and agreements; and liabilities effecting the assets, contingent or otherwise.

(2) Leasehold Rights. You agree, at our election, to assign your leasehold interest in the Location to us or, to enter into a sublease for the remainder of the lease term on the same terms (including renewal options) as the prime lease.

(3) Purchase Price. The purchase price for the BUSINESS will be its fair market value, determined in a manner consistent with reasonable depreciation of the BUSINESS's equipment, signs, inventory, materials and supplies, provided that the BUSINESS will be valued as an independent business and its value will not include any value for the Franchise or any rights granted by this Agreement, the Marks, or participation in the network of **DELICIOUS RESTAURANT** businesses.

(4) Fair Market Value. The BUSINESS's fair market value will include the reasonable goodwill you developed since your commencement of operations that exists independent of the goodwill of the Marks and the System. The length of the remaining term of the lease for the Location will also be considered in determining the BUSINESS's fair market value.

(5) Exclusions. We may exclude from the assets purchased hereunder cash or its equivalent and any equipment, signs, inventory, materials and supplies that are not reasonably necessary (in function or quality) to the BUSINESS's operation or that we have not approved as meeting standards for **DELICIOUS RESTAURANT** businesses, and the purchase price will reflect such exclusions.

(continued)

EXHIBIT 5.1 Our Right to Purchase Business *(continued)*

(6) Valuation. If we and you are unable to agree on the BUSINESS's fair market value, its fair market value will be determined by a valuation analyst agreeable to both parties. If we and you are unable to agree on a valuation analyst, then the BUSINESS's fair market value will be determined by three (3) independent valuation analysts who collectively will conduct one (1) valuation. We will appoint one valuation analyst, you will appoint one valuation analyst and the two party appointed analysts will appoint the third valuation analyst. You and we agree to select our respective valuation analysts within fifteen (15) days after the date we determine that we are unable to agree on the BUSINESS's fair market value, and the two valuation analysts so chosen are obligated to appoint the third valuation analyst within fifteen (15) days after the date on which the last of the two party appointed valuation analysts was appointed. You and we will bear the cost of our own valuation analysts and share equally the reasonable fees and expenses of the third valuation analyst chosen by the two party appointed valuation analysts. You and we will take reasonable actions to cause the valuation analysts to complete their appraisal within thirty (30) days after the third valuation analyst's appointment.

(7) Closing. The purchase price will be paid at the closing of the purchase, which will take place not later than ninety (90) days after determination of the purchase price. We have the right to set off against the purchase price, and thereby reduce the purchase price by, any and all amounts you or your Owners owe to us.

(8) Instruments. At the closing, you agree to deliver instruments transferring:

(a) good and merchantable title to the assets purchased, free and clear of all liens and encumbrances (other than liens and security interests acceptable to us, if any), with all sales and other transfer taxes paid by you; and

(b) all licenses and permits of the BUSINESS which may be assigned or transferred; and

(c) the leasehold interest in the Location and improvements thereon.

(9) Escrow. If you cannot deliver clear title to all of the purchased assets, or if there are other unresolved issues, the closing of the sale will, at our election, be accomplished through an escrow arrangement with an independent escrow agent selected by us.

(10) Releases. You and your owners agree to execute general releases, in form satisfactory to us, of any and all claims against us and our shareholders, officers, directors, employees, agents, successors and assigns.

So, what do the terms in exhibit 5.1 mean? This franchise agreement gave the franchisor the right to purchase the business at fair market value at the end of its 15-year term. This would provide the franchisee with a potential exit opportunity, which is a good thing, right? Well, not quite. This particular business was relatively capital-intensive, with about a $1.5 million initial capital investment and a requirement to upgrade and renovate its facility every 5 years, which could cost anywhere between $300,000 and $500,000. All of the costs associated with advertising and building out the facility were the responsibility of the franchisee. Due to the nature of the business, revenues tended to peak in the third or fourth year and then gradually declined as competing businesses opened up in the area. At 10 years, many of these types of businesses were generating declining revenues and minimal (if any) profitability. This gave the franchisor the ability to purchase the business (equipment and all) at a depressed fair market value. In addition, the company would be valued as a standalone business without the use of any franchise trademarks. As an investor, would you be willing to make a $2 million to $3 million capital investment if, at the end of the franchise agreement term, you were obligated to sell the business and all of its assets for a depressed value? This would certainly affect the value of the business.

Some companies provide services to other companies under contracts that define the extent and cost of those services. In these cases, the agreement between the two companies can be very important to the valuation, especially if the company providing the service has only one or two clients. Selected portions of an agreement between a hospital and a health care management company are shown in exhibit 5.2. In this case, the management company made operational decisions for two hospitals, so the terms of the management agreements were extremely important to the valuation.

EXHIBIT 5.2 Management Agreement

ARTICLE V
COMPENSATION

5.1 Management Fees. Subject to Section 5.2 below, as full and exclusive compensation for all of the services to be rendered by Manager during the Term, Company shall pay to Manager by the 15th day of each calendar month, beginning on January 1, 2012, at its principal office, or at such other place as Manager may from time to time designate in writing a monthly fee (the "Management Fee") equal to four percent (4%) of Revenues of the Facility derived for each calendar month of the Term. The Management Fee shall be calculated based upon the estimated Revenues of the Facility for such month. The Management Fee shall be reconciled on a quarterly basis based upon actual Revenues for the Facility. For the purposes of determining the Management Fee, "Revenues" means all revenues collected by Company in accordance with generally accepted accounting principles ("GAAP"), including, without limitation, all patient and/ or resident revenues received or receivable for the use of, or otherwise by reason of, all rooms, beds, units and other facilities provided, meals served, services performed, space or facilities subleased or goods sold on or from the Facility and all revenues for graduate medical education that are received or receivable by the Facility; provided, however, that Revenues shall not include non-operating revenues such as interest income or gain from the sale of assets not sold in the ordinary course of business; and provided, further, that there shall be excluded or deducted (as the case may be) from such revenues; (i) contractual allowances for billings not paid by or received from the governmental authorities or third party payors, (ii) allowances according to GAAP for uncollectible accounts, (iii) all proper patient or resident billing credits and adjustments according to GAAP related to health care accounting, (iv) deposits refundable to patients/ residents of the Facility, (v) provider discounts for hospital or other medical facility utilization contracts and (vi) any Grants and Subsidies (as defined herein). "Grants and Subsidies" includes all state and local charity care subsidies, hospital relief subsidies, mental health subsidies, stabilization grants, and any other similar grants or subsidies received by the Facility from whatever source derived, and any and all grants, subsidies or incentive payments received by the Facility, from a governmental source, in connection with the Facility's implementation of an electronic based medical records or electronic-based prescription system at the Facility.

ARTICLE VI
TERMINATION RIGHTS

6.1 Termination by Company. (a) After the Initial Term of this Agreement, this Agreement may be terminated at Company's option, without cause and for any reason, upon one hundred twenty (120) days prior written notice to Manager.

(b) If at any time or from time to time during the Term Manager shall fail to keep, observe, or perform any material covenant, agreement, term or provision of this Agreement to be kept, observed, or performed by Manager, and such default shall continue for a period of thirty (30) days after written notice thereof by Company to Manager or, if such default is not subject to cure within thirty (30) days, such longer period as may be required to effect a cure, provided that Manager initiates certain action within such 30-day period and thereafter is diligently and in good faith pursuing such cure, then Company shall have the right to terminate this Agreement immediately and without any notice.

Although there were other terms in the agreement that had to be considered in the valuation, the terms associated with compensation and termination had the largest impact. The agreement tied the management company's revenue potential to the revenues of the hospital it was managing. This required us to analyze the hospital's future revenue potential. The termination clause allowed the hospital to exit the agreement with 120 days' notice for any reason, which was a primary source of risk for the management company. The two hospitals managed by the subject company in this case were related by common ownership. Therefore, if the owners of one hospital did not like the way the management company was running one facility, they could very well decide to cancel both contracts, which would have effectively reduced the management company's earning potential to zero.

Non-competition agreements, or covenants not to compete, can have a huge impact on the value of a business that depends on key managers or owners. Think about a medical practice with a single doctor, who has developed professional relationships with his or her patients over 20 years. If another firm was to purchase the practice without the use of a non-compete agreement, the doctor could open up next door, and many of the patients at the purchased practice would leave to follow their long-time doctor. However, there are a number of factors to consider in valuing a non-compete agreement (which I will not go into in depth here) and, in some cases, those factors can only be considered through a review of the actual agreement. One such factor is whether or not the non-compete agreement is enforceable under state law. Depending on statutes (or case law, if no statutes exist), there is a chance that the terms of the governing agreement are too restrictive or not adequately defined, which may result in an agreement that is not considered to be enforceable (and, thus, would have zero value). Non-competition agreements will be discussed further in chapter 22.

All the preceding scenarios are meant to illustrate the importance of legal documents to any valuation. It is imperative that the valuation analyst consider all legal documents pertinent to the valuation subject and its value.

Products and Services

It is generally a good idea to understand information about the products and services that the valuation subject sells to its customers. Besides the fact that you need to know this information to select guideline companies, it is also imperative that the valuation analyst understand information about factors that affect these products and services. For example, how do changes in the economy affect the demand for the products? A rise in interest rates would certainly have an impact on an automobile dealership. In fact, rising interest rates will cause new car sales to go down. However, rising interest rates will also cause people to keep their cars for a longer amount of time, thereby requiring more maintenance. That could cause the repair bays to become busier. It is also important to understand what alternative products are available in the marketplace to assess the future success of the products. If you were valuing a company that sold a standalone digital music device and did not have the ability to sell other more versatile mobile media devices, for example, Android phones and tablets, the likelihood that the company would continue to be successful in the future is slim because everyone and their mothers (even me) now own some type of mobile media device.

Markets and Marketing

Part of the valuation process includes understanding the markets served by the valuation subject. Geographic diversification frequently does not exist for very small businesses. However, understanding the market for the products or services allows the valuation analyst to assess the degree of risk relevant to the lack of diversification. Understanding the market will also allow the valuation analyst to determine if there are alternative products in the marketplace that will have an effect on the subject company. Keep in mind that even smaller businesses are now able to diversify geographically, particularly with the Internet as a resource.

The marketing efforts of the subject company should also be considered because a large, visible company in the market will frequently attract more new customers than an obscure company that the public has never heard of.

Physical Facilities

Factors to be considered in a business valuation assignment include information about the physical plant. This information would pertain to the plant's size and whether it is owned or rented, as well as the amount of room available for expansion. The valuation process requires the use of projections, which must consider whether the facilities are large enough to meet the expected production forecasts. If a plant is at full capacity and management provides the valuation analyst with forecasts that include significant growth, how can that growth be achieved without either expanding the current facilities or relocating to larger quarters? Either way, there will be an additional expense incurred by the company if it is to meet its expansion projections.

Equipment

It is generally a good idea for a valuation analyst to learn about the equipment that is employed by the business to accomplish its business purposes. Even if an appraisal of the equipment is unnecessary, the valuation analyst should find out information about the type of equipment used, the age of the equipment, its capacity, its maintenance schedules, the availability of parts, and its approximate replacement cost. The valuation analyst should also inquire about whether there is newer technology being used by the competition.

Older equipment usually means higher maintenance costs and a lower level of productive capacity. This could be an essential component of a cash flow forecast because asset replacement can be costly. Older equipment could mean difficulty in getting parts and service, which could force the replacement of equipment, creating a financial hardship for the company. However, there are many companies that can continue to use older equipment for a long time without a problem. These companies generally have a well-established maintenance schedule, and by examining the equipment, you can generally tell whether it is regularly maintained.

The valuation analyst should ask to review insurance policies to get an idea of the amount of coverage the company is carrying so that the valuation analyst can "ballpark" the replacement cost of these assets. The valuation analyst should also make certain that these policies have been kept up to date. Otherwise, the company may be exposed to an additional risk attributable to the replacement of the equipment in the event of a loss. This should be self-explanatory, but let me give you a true example. Over the course of a valuation I completed a while back, I discussed with management the fact that they received a $3.2 million insurance settlement as a result of Hurricane Wilma. Since then, the company's insurance premiums had risen so much that they had to lower the coverage to $1.0 million. Think about the added exposure that the company has in the event of another hurricane. Although the valuation analyst does not necessarily forecast hurricanes, the business is in Florida (home of the hurricanes—and I do not mean the type you drink!).

Personnel

The valuation analyst should seek information about the personnel requirements of the company. This includes gaining an understanding of the role of key persons in the company. In smaller companies, the owner is frequently the key person. The valuation analyst must determine what it would take to replace that individual with someone who is capable of getting the job done. Sometimes this may take two or more people. Other times, it may take people with different skills from those the owner has.

For example, in valuing an internal medicine practice, the valuation analyst may find that the doctor does not trust anyone in his or her office to do the bookkeeping. Therefore, the doctor performs this function in addition to all of the duties of being a doctor. What if the doctor is turning away new patients due to a lack of time because the bookkeeping is taking up 10 hours per week? The valuation analyst would consider replacing the doctor not only with another doctor but also with a part-time bookkeeper, which would allow the new doctor to spend the additional 10 hours seeing new patients. You are probably asking yourself, "What kind of doctor would do this?" If I had not seen this in reality, I could not have provided you with this example!

Other Stuff

The valuation analyst should pay particularly close attention to other items that may exist for the valuation subject. These may include, but should not be limited to, operating data about the company's products, competitors, suppliers, and customers so that you can demonstrate a clear understanding of the valuation subject. These items will help you make a determination regarding the risk involved in the subject company's business. For example, few products, many competitors, high employee turnover, few sources of supply, and dependence on key customers add up to a lot of risk. This will affect value.

Other stuff can include information about patents, copyrights, proprietary processes, pending litigation, and environmental exposure. These items will either increase or decrease the value of a company, depending on the competitive advantage or disadvantage that may come with these items. Sometimes a valuation analyst will find that the competition holds an important patent in the field; therefore, breaking into the field may be impossible without different technology. All of these situations should be considered during the valuation process.

If the valuation is for an employee stock ownership plan (ESOP), make sure you get a copy of the plan documents so that you fully understand the terms. This will have an impact on marketability discounts, as well as on other factors affecting your valuation. Because most small- and medium-sized businesses do not have ESOPs, I have not included a discussion about them in this book.[1]

As noted earlier, legal documentation (including copies of legal contracts and agreements affecting the company) should also be obtained. This will allow the valuation analyst to determine if there are any restrictions on the operations of the business, any restrictions on the owners, or any commitments that will require the company to perform in a certain manner that can affect operations in the future. You saw what a difference it made in my IRS job. Find out if there are any lawsuits against the company, either pending or threatened. A lawsuit may affect the financial success of the company and should be considered as a risk factor even if it cannot be quantified.

Financial Information

The financial information requested will include annual financial statements for a relevant period of years. Most often, five years of data is obtained, but the valuation analyst should consider whether to ask for a longer or shorter period of time, if appropriate. This information should be from the most recent years preceding the valuation date. Ideally, the analyst would like to get as many years' financial statements as may be applicable to the subject's business cycle. This way, a more complete picture of the company can be obtained. Frequently, we ask for six years of financial statements so we can calculate a five-year compound annual growth rate. The procedures for performing this calculation will be discussed later.

Tax returns for the same period should be requested, so that any differences between tax and financial reporting that need investigation can be determined. Tax returns will also identify any subsidiaries that are part of a consolidated tax return or any other companies that are part of a controlled group of companies, as defined by the IRC. This may make the valuation analyst aware of other companies that may need to be considered during the valuation process. Even if the valuation assignment does not include the other companies, there can be transfer-pricing issues, dependence on the other companies, or a splitting of costs that would be discontinued if the valuation subject was sold.

Interim financial statements should be obtained for the period prior to the valuation date, and, if possible, for the same period in the prior year. This provides financial statements that may be closer to the effective date of the valuation, as opposed to the prior year-end, and also allows the valuation analyst to calculate the financial statements on a latest 12-month basis. I will demonstrate this shortly, so just be patient. Internal financial statements should be more carefully scrutinized because they may exclude many of the adjustments that the outside accountant makes at the reporting period. External financial statements must also be analyzed to ensure consistency in the reporting between the year-end and interim periods. For example, the interim financial statements may record inventory using the gross profit method (as a reasonable shortcut), whereas at year-end the company takes a physical inventory and values it properly.

Copies of forecasts or projections should be requested for several reasons. First, valuation is a prophecy of the future, and there may be no better indication than management's estimate of what it expects to happen. Second, reviewing prior budgets or forecasts and projections may provide the valuation analyst with a better understanding of how well management is able to direct the company's activities. I previously mentioned the forecast that management did in a litigation case that we finally got our hands on. They even valued a piece of the business for us.

The valuation analyst should request supporting information for the balance sheet items that may require fair market value adjustments. This is more important in valuing a controlling interest than a minority interest because the minority interest generally does not have the ability to liquidate the assets to realize the fair market value.

1 For more information about employee stock ownership plans (ESOPs), see Willamette Management Associates, *Guide to ESOP Valuation* (self-published); Larry R. Cook, *Financial Valuation of Employee Stock Ownership Plan Shares* (Hoboken, NJ: John Wiley & Sons, 2005); or The National Center for Employee Ownership, *ESOP Valuation*, 3rd ed.

The valuation analyst should also request supporting information for income statement items that may require normalization adjustments. We will discuss the normalization process in chapter 6. For now, accept the fact that normalization is the process of removing those items from the financial statements that do not contribute to the economic earnings of the subject company on a prospective basis. This will make more sense in a little while.

External Information

During the valuation process, the valuation analyst will also be required to perform research to obtain information about the environment in which the business operates. This information is known as *external information*. Some of the more important information that should be explored includes (1) economic data, (2) industry data, (3) publicly traded guideline company data, (4) transaction data, and (5) other miscellaneous data.

Revenue Ruling 59-60 specifically states that one of the factors to be considered in the valuation of a closely held business is "the economic outlook in general and the condition and outlook of the specific industry in particular." Economic and industry information are key components of a business valuation assignment. Analysis of these items is discussed in the next chapter.

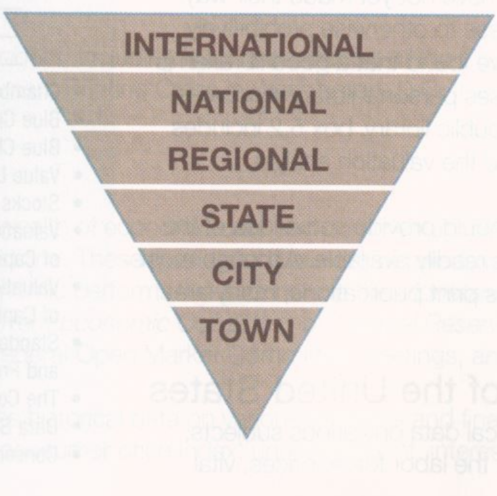
Economic Data

Various economic data should be gathered by the valuation analyst. This data will allow an assessment of how the subject company will be affected by changes in the economy. For example, rising residential mortgage interest rates may adversely affect a construction company that is primarily engaged in building new houses. Changes in consumer confidence can affect a retail business.

An analysis should be performed to see how the subject company has performed in light of past economic cycles, and the past performance may be used to project how the company is expected to do based on economic forecasts. The analysis should consider all aspects of the economy that directly or indirectly affect the valuation subject. The valuation analyst should also think in terms of the factors that might affect the subject company's customers or suppliers. Too often, these factors are overlooked.

A global approach to considering economic data is illustrated in figure 5.1. A broad spectrum of information should be considered with respect to the economy. Starting with the big picture, the valuation analyst should consider the international economic factors that may affect either the valuation subject or its customers or suppliers. The availability of supply, exchange rates, fluctuations in economic conditions abroad, and trade restrictions will all affect a global company.

Figure 5.1



After the global aspects of the economy are considered, the national economy should be next. After that, the geographic regions get smaller and smaller, but even the town in which the business operates could be extremely relevant to the valuation. What if a company depends on a military base for its business and the government announces a base closure? This can have a devastating effect on the company as well as on the community in which the company operates. The same holds true for communities after a layoff is announced by a major employer. However, this could be good news if the valuation subject has experienced a shortage of qualified labor and people now become available to them.

The local economy becomes an important component in the valuation of a small neighborhood business. Some of the factors and key economic indicators that should be considered and reviewed regarding the local economy can be found in box 5.1. For each of the items in box 5.1, the relevance to the valuation subject is important. Rarely will all of these factors be included in one valuation. The valuation analyst should not use a boilerplate discussion of the economy. I have seen a growing number of valuation analysts purchase an economic report from one of the data providers and merely slap it into an appendix at the back of their report. This is a very poor practice and is nothing more than a lazy way to try to comply with standards and the factors from Revenue Ruling 59-60. The economic data that should be included in a report should be relevant to the valuation subject and not merely boilerplate. Clearly, the economic factors that affect a construction company will be substantially different from the economic factors that affect a medical practice. When was the last time mortgage rates affected whether a person went to the doctor? Even with the high cost of health care, mortgage rates are not yet part of the discussion in the valuation of a medical practice.

There is a tremendous amount of economic data available on the Internet, but that does not mean you should abandon your local library. Often, the local public or business school library is the best place to find items that have not yet made their way on to the Internet or to gain access to otherwise prohibitively expensive databases. Also, I have found that a good librarian is invaluable. Whether he or she uses personal library resources, relies on the Internet, or uses a public library, box 5.2 includes sources that should be familiar to the valuation analyst.

The items included in box 5.2 should provide some idea of the abundance of information that is readily available. Although most of these resources started out as print publications, many are also available on the Internet.

Statistical Abstract of the United States

This publication provides statistical data on various subjects, including population, education, the labor force, prices, vital

BOX 5.1 Key Economic Indicators

- Foreign trade
- Foreign currency
- Gross domestic product
- Federal deficit and debt burden
- Inflation—consumer price index
- Unemployment
- Consumer confidence
- Business investment
- Interest rates
- Housing starts
- Building permits
- Demographics
- Health care
- Gross state product
- Labor supply
- Local unemployment
- Disposable income
- Wages
- Availability of materials
- Taxes
- Growth trends

BOX 5.2 Sources of Economic Data

- Statistical Abstract of the United States
- Economic Report of the President
- Federal Reserve
- Congressional Budget Office
- Survey of Current Business
- Annual Metro, City, and County Data Book
- Business Conditions Digest
- Monthly Labor Review
- The Wall Street Journal
- Business magazines
- Trade magazines
- Professional magazines:
    - — Medical Economics
    - — Electrical World
- State agency reports:
    - — Employment
    - — Planning
    - — Economic development
    - — State websites
- Chambers of commerce
- Blue Chip Economic Indicators
- Blue Chip Financial Forecasts
- Value Line Investment Survey
- Stocks, Bonds, Bills, and Inflation Yearbook
- Valuation Handbook: U.S.Guide to Cost of Capital
- Valuation Handbook: U.S. Industry Cost of Capital
- Standard & Poor's Industry Surveys, Trends and Projections
- The Complete Economic and Demographic
- Data Source
- Consensus Forecasts—USA

statistics, the environment, income, gross domestic product (GDP), science, transportation, agriculture, construction and housing, trade, business enterprise, and energy. In addition to statistics, each subject contains a brief explanation of the contents of the data.

The statistical data is presented in various ways (graphs, tables, charts, and maps), depending on what is appropriate for the subject being analyzed. The data is also shown historically as percentage changes computed annually and monthly; in some cases, projections are given. The data is also divided into such classifications as age, race, marital status, sex, and religion. This book can be a useful resource tool because a huge collection of data regarding the nation is compiled into one reference source.

Until 2011, the *Statistical Abstract of the United States* was issued by the U.S. Department of Commerce, along with the Economics and Statistics Administration and the Bureau of the Census, and was made available for distribution by the U.S. Government Printing Office in Washington, D.C. In 2011, the Bureau of the Census determined that it would no longer prepare this publication due to budget cuts. The last version published by the U.S. Department of Commerce (fiscal 2011) and prior editions of the *Statistical Abstract of the United States* are available online at www.census.gov/library/publications/time-series/statistical_abstracts.html. This website also contains links to the sources that were previously used to compile the data contained within the abstract, which makes it a good (free!) starting point for economic research.

If you absolutely must have the *Statistical Abstract of the United States* in its published form, ProQuest has taken over the task of updating and releasing the publication. For more information, visit the ProQuest website online at www.proquest.com/products-services/statabstract.html. If you want this resource for free, steal it from your local library if they have it (only kidding!). Your local library may have a subscription.

Economic Report of the President

This publication, which includes the *Annual Report of the Council of Economic Advisers*, contains the President's report on the economic condition of the United States to the Speaker of the House of Representatives and the President of the Senate. The *Annual Report of the Council of Economic Advisers* is an excellent source of various economic data relating to the nation. In this report, the council provides summarizations and corresponding charts on the various aspects of the U.S. economy for a specific time period, as well as the indicators that affect economic growth. Health care reform, income, inflation, monetary policy, trade policy, taxes, employment, economic trends, and the status of the United States in the global marketplace are discussed.

In addition, the book provides tables, charts, and boxes (highlighted captions that give further explanations and the views of the U.S. administration) pertaining to the economic condition at the time. The data in these tables and charts gives historical, current, and projected figures and is presented on an annual basis; for more current years, it is also presented on either a monthly or quarterly basis. The *Economic Report of the President* is a useful tool in the search for the economic condition of the nation, as well as for its future outlook and data relating to it.

The *Economic Report of the President*, including the *Annual Report of the Council of Economic Advisers*, is distributed by the U.S. Government Printing Office in Washington, D.C. It is available free online at www.gpo.gov/erp/. I like free!

Federal Reserve

The Federal Reserve provides a wealth of economic data and commentary on various aspects of the U.S. economy via a number of publications. These publications provide detailed insight into monetary policy, economic outlook, and past economic performance and include the *Monetary Policy Report to the Congress*, *Summary of Commentary on Current Economic Conditions by Federal Reserve District* (commonly referred to as the Beige Book), minutes of Federal Open Market Committee meetings, and the *Federal Reserve Bulletin*.

The Federal Reserve also provides historical data on various business and financial subjects, such as money, stock and bank credit, GDP, the consumer price index, unemployment, interest rates, real estate, financial markets, the stock market, securities, production, consumer credit, and income. This data is presented historically, annually, quarterly, monthly, or in combination and may be downloaded in spreadsheet format from the Federal Reserve's website at www.federalreserve.gov, and it is all available for free (there's that word again!).

Congressional Budget Office

The Congressional Budget Office (CBO) provides information about the U.S. economy and federal budget. Anticipated levels of government expenditures, labor force and population growth, GDP growth and inflation, among other economic indicators, are provided through the various reports published by the CBO. Additionally, the CBO provides insight into government involvement in key industries, such as energy, health care, defense, and housing. Data provided by the CBO differs from other economic projections in that it often provides scenarios of economic consequences under different legislative actions. This information can all be found at www.cbo.gov/topics.

It should go without saying that the figures provided within the Congressional budget should be used cautiously. Budgets frequently change, as has been quite evident with bipartisan turmoil in Congress regarding federal deficits and debt. Nonetheless, the CBO can provide a general indication about the direction in which spending is headed in the future and its effect on the economy or a certain industry. This can be particularly important for companies reliant on Medicare reimbursements, energy subsidies, or defense contractors.

Survey of Current Business

This publication contains information from the National Income and Products Accounts (NIPA), which is used to add up GDP. A regular feature of this monthly publication is a description of the business situation, which is done in summary, tabular, and chart form. Economic growth as measured by the GDP, consumption expenditures, investments, interest rates, housing, imports and exports, the gross state product, involvement of the United States in foreign business, and other data that can be of use in analyzing the nation's economy can also be found in this publication.

Survey of Current Business is issued by the U.S. Department of Commerce, Economics and Statistics Administration and the Bureau of Economic Analysis (BEA) and is distributed by the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. This monthly publication is also available at no cost on the BEA website at www.bea.gov/scb/index.htm.

Stocks, Bonds, Bills, and Inflation® Yearbook

This publication is an annual yearbook that contains historical data about returns in the capital markets since 1926 and through the current year. It supplies useful investment information and features sections reflecting highlights of the current year's market, major events, and highlights from the previous decade, along with corresponding charts and tables for further explanation.

A section of the book is devoted to returns on stocks and bonds of various types, along with statistical data and formulas, returns for different sizes of firms, and cost of capital and discount rate information. I discuss this publication in greater detail in chapter 13.

Stocks, Bonds, Bills, and Inflation® Yearbook (SBBI Yearbook) is published annually by John Wiley & Sons, Inc. More information on SBBI can be found on the Wiley website at www.wiley.com/WileyCDA/WileyTitle/productCd-1119316405.html. As will be discussed in chapter 13, Morningstar previously published a valuation edition of SBBI, which was discontinued in 2014.

Valuation Handbook: U.S. Guide to Cost of Capital

After Morningstar discontinued the valuation edition of SBBI, Duff & Phelps picked up the reigns and began compiling the *Valuation Handbook: U.S. Guide to Cost of Capital*, which is published by Duff & Phelps. This publication contains much of the information that was previously contained within the valuation edition of SBBI. It will be discussed in much greater detail in chapter 13. For now, it is important to note this publication as an additional source of historical data related to rates of returns.

Valuation Handbook: U.S. Industry Cost of Capital

This book is compiled annually by Duff & Phelps and is published by Duff & Phelps, with quarterly updates also available. The purpose of the book is to provide additional data that can be used to estimate the cost of capital. It does this by providing cost of capital information that is broken down by various industries. Within each of these industries, the data is also broken down by company size.

The information provided includes compound annual equity returns, five-year growth in net sales, and operating income and net income, as well as margins, capital structure ratios, equity valuation ratios, and betas.

Valuation Handbook: U.S. Industry Cost of Capital is a continuation of Morningstar's *Cost of Capital Quarterly*, which was discontinued along with the valuation edition of SBBI in 2014. I'll discuss the *U.S. Industry Cost of Capital* publication again in chapter 13.

Newspapers and Magazines

Business Week publishes a number of articles that offer regular analysis on economic conditions, including "Economic Trends" and "Business Outlook." In addition, *Business Week* publishes a special edition in January covering a variety of industries. *The Wall Street Journal* publishes a column called "Tracking the Economy Statistics" on a weekly basis. Columns such as these can provide good additional perspective about how others are interpreting raw macroeconomic data.

Internet Sources of Economic Information

The federal government collects vast amounts of economic and demographic data for the United States as a whole, as well as for states, counties, and many cities. Data is also collected on various industries. The information is available in print form and electronically on the government's many websites. Although the government-produced data may be available through other vendors' online services and print or electronic products, there is little reason to ever pay for this data, unless what you are looking for is very old. In that case, you might be better off in the public library.

Every department, bureau, and section of the federal government has a website. Every state in the United States has a website containing a variety of information about the state. Almost every U.S. county and many U.S. cities have websites as well. These may contain information of interest only to a tourist or other visitor, but some may also have economic or business information.

This section deals exclusively with electronic data sources located on the Internet. Let's begin with the U.S. federal government and then review private sources of data. Some of these websites are free and others are subscription services, which charge either a flat annual fee or a fee per use or article. Many of these websites are so rich that inclusion of the addresses of individual pages would become cumbersome. Therefore, I am only giving you the address of the home page and inviting you to visit the sites and explore them by clicking on the links. Do it in your spare time.

The discussion is subdivided into sections as follows:

- International information
- National information
- State and local information
- Market data (stocks and bonds)

International Information

International Data

Many of the websites I mentioned earlier include international information, as well as U.S. information. The Federal Reserve Board's website includes links to foreign central banks, which may have data on conditions in the countries in which they are located.

International Trade Administration (http://trade.gov)

This site helps U.S. businesses participate fully in the growing global marketplace. The mission of the International Trade Administration of the Department of Commerce is to strengthen the competitiveness of U.S. industry, promote trade and investment, and ensure fair trade and compliance with trade laws and agreements. A related site, the U.S. Government Export Portal at http://export.gov, provides information for those businesses wanting to expand their export markets.

Organization for Economic Cooperation and Development (www.oecd.org)

This website has economic surveys for all member countries and some nonmember countries. Select data is available for free at www.oecd.org/statistics/. In most cases, you can download data in Microsoft Excel format, which makes for easier analysis.

CIA (https://www.cia.gov/library/publications/the-world-factbook/index.html)(www.cia.gov/library/publications/the-world-factbook/index.html)

The World Factbook is produced by the Central Intelligence Agency (CIA) and provides information on every country on the planet. Topics include geography, the people, government, economy, communications, transportation, military, and transnational issues. Some of the information might be a year or two old, but it will give a good overview of the country. *The World Factbook* is produced annually and can be downloaded from the CIA website starting with the 2000 edition at www.cia.gov/library/publications/the-world-factbook/. Who knows, with this website, you may even learn how to become a spy!

Countries' Embassies

Every country that has an embassy in the United States has a website, and these websites have a wealth of good information about the countries and, quite often, data on trade with the United States. You can find these using a search engine, such as Google.

National Information

FedStats (http://fedstats.sites.usa.gov/)

FedStats, perhaps the most comprehensive and easy-to-use government website, provides the full range of official statistical information available to the public from the federal government. Use the Internet's powerful linking and searching capabilities to track economic and population trends, health care costs, aviation safety, foreign trade, energy use, farm production, and more. Access official statistics collected and published by more than 100 federal agencies without having to know in advance which agency produces them. All of the statistical information available through FedStats is maintained and updated solely by federal agencies on their own web servers. And it's all free. The FedStats home page begins with easy-to-use links to statistics and statistical agencies, which are summarized in box 5.3.

BOX 5.3 Related Resources Accessible Through FedStats

- Topic links—A to Z (direct access to statistical data on topics of your choice—there are more than 400 of them)
- MapStats (statistical profiles of states, counties, Congressional districts, and federal judicial districts)
- Program/Subject areas are linked to summaries of the major statistical programs, such as agriculture, education, energy, and income, among many others
- Search by key words or phrases across all linked agency websites
- Agencies listed alphabetically (with descriptions of the statistics they provide and links to their websites, contact information, and key statistics)
- Press releases (the latest news and announcements from individual agencies)

Three principal statistical agencies gather data on economic activity, demographic trends, and industry developments in the United States, nationally, and on the state and local levels. These are as follows:

Bureau of Economic Analysis (BEA) (www.bea.gov)

The BEA measures, presents, and interprets gross domestic product, personal income, corporate profits, and related items in the context of the NIPA. The BEA also maintains personal income and related measures for states and localities, the U.S. balance of payments accounts, and the foreign direct investments accounts. Data is released monthly in the *Survey of Current Business* (available both in print and on the Internet) and can be downloaded in spreadsheet format using the website's interactive tables.

Bureau of Labor Statistics (BLS) (www.bls.gov)

The BLS produces statistics on employment and unemployment, consumer expenditures, prices and living conditions, wages and employee benefits, productivity and technological changes in U.S. industries, projections of economic growth, the labor force, employment by industry and occupation, and occupational injuries and illnesses. This data can be downloaded in spreadsheet format using the website's interactive tables.

Bureau of the Census (www.census.gov)

The Census Bureau provides information on the number, geographic distribution, and social and economic characteristics of the nation's population. It conducts several periodic censuses every 5 years, covering the years ending in "2" and "7." The Economic Censuses include those of manufacturing, mineral industries, construction industries, retail and wholesale trade, service industries, and transportation and other businesses. The Census of Governments collects state and local data on public finance, public employment, and governmental organization, powers, and activities. Thousands of data series can be accessed by using the American FactFinder tool on the website.

The Census Bureau operates the Census Information Center (CIC) program, which is a cooperative effort between the U.S. Census Bureau and 52 national, regional, and local nonprofit organizations (including universities). These are listed at www.census.gov/about/partners/cic.html and can be sources of additional, more specific data. The organizations range from the Arab American Institute to the William C. Velazquez Institute; contact information is available, including email addresses and websites.

A number of other statistical agencies collect data on more specific areas of the economy. For example, the Bureau of Transportation Statistics gathers data on the nation's transportation systems, and the Energy Information Administration collects information on energy reserves, production, consumption, and so on. Each of these agencies' websites can be accessed through FedStats. Most recent years' statistics and contact information are available.

USA.gov (www.usa.gov)

This is an official U.S. government website that allows visitors to browse by topic and includes topics from Agriculture and Food (farms, food, and nutrition) to the United States in the World (defense, trade, and immigration). These topics provide links to the agency involved. There are links to the executive, legislative, and judicial branches of the federal government, as well as links to state and local governments. This site is free.

Federal Reserve (www.federalreserve.gov)

As I pointed out earlier in this section, the Federal Reserve provides numerous publications related to economic data, interest rates, monetary policy information, and international information. These publications, as well as all of the Federal Reserve's statistical releases (daily, monthly, quarterly, and so on) are available online. There are also links to each of the 12 regional Federal Reserve District Banks (www.federalreserveeducation.org/about-the-fed/structure-and-functions/districts/). Federal Reserve District Banks' websites contain district economic activity and other economic research. Many of the research pieces are very academic and technical, but some may be useful in a valuation analysis.

The Conference Board (www.conference-board.org)

This is a not-for-profit, worldwide research and business membership organization and a leading private source of economic and business intelligence. The Economics Program is a recognized source of business economics research and objective indicators, analyses, and forecasts. Several widely watched economic indicators are published by this program, including Consumer Confidence, Help-Wanted Advertising, U.S. Leading Economic Indicators, U.S. Regional Performance, and Business Executives' Expectations. U.S. Leading Economic Indicators were once produced by the Bureau of Economic Analysis. Business cycle indicators and general information about the economy are located at www.conference-board.org/data/bci.cfm as a public service. A subscription to Business Cycle Indicators is $908 annually.

Economagic (www.economagic.com)

This is a free service where you can browse over 400,000 data series within your Internet browser. You can browse by region or by source. Most of the data is from U.S. federal statistical agencies, but there are some links to foreign sources and a few trade associations and private companies. Although there is a lot of free data here, not all of it is currently updated.

According to the website, Economagic is meant to be a comprehensive site of easy-to-access economic time series data useful for economic research, particularly economic forecasting. The core data sets contain macroeconomic data at the national level; however, much of it is at the local level. Although data is visible within an Internet browser, a subscription is needed to download the data in spreadsheet format or to access economic forecasts. A one-year subscription to access all information offered on this site is $200.

Moody's Analytics (www.economy.com)

This site has sections that are free and others that offer reports for a fee. Some specific areas of this website are as follows:

- *FreeLunch.com* (www.freelunch.com). Free access to over one million economic time series in Excel file format—easy to use. Who says there is no such thing as a free lunch?
- *The Dismal Scientist* (www.dismal.com). Covers detailed information on the U.S. and global economies. This website is excellent because it includes analyses as well as raw data.

Mercer Capital (www.mercercapital.com)

The National Economic Review, an overview of the national economy prepared specifically for the business valuation profession, is available on the Mercer Capital website. The reports take information from many business publications and government-produced data, are about 9 to 10 pages long, and include tables of statistics and references. They are offered on a subscription basis (quarterly issues), and quarterly reports can be obtained by request all the way back to 1992. A 1-year subscription costs $250 (2 years for $399), and individual quarterly reviews sell for $150 each. The subscriptions may be worth it if you are not comfortable with interpreting the myriad statistics that are released each quarter on the nation's economy.

BV Resources (www.bvresources.com)

Economic Outlook Update is a quarterly update on the national economy that provides excellent support for the economic outlook section of a valuation report. This publication also has a monthly update. The quarterly report includes general economic indicators, consumer prices, inflation rates, interest rates, unemployment, consumer spending, the stock and bond markets, construction, manufacturing, future outlook, and more. A one-year subscription costs $339.

State and Local Information

U.S. Census Bureau (www.census.gov)

This site gathers and provides data at the state and local levels through the Economic Census link on its home page. This data includes industries in the area, number of establishments, number of employees, annual payroll, and sales. Data comes from the most recent economic census (year ending in 2 or 7). Data on population trends, employment, income, and other demographics is available at the county level as well.

The Census Bureau operates the State Data Center (SDC) program, a cooperative effort between the states and the Census Bureau that was created in 1978 to make data available locally to the public through a network of state agencies, universities, libraries, and regional and local governments. More information about this program and access to links to each SDC are available at www.census.gov/about/partners/sdc.html. This web page has a map of the United States, and one mouse click will bring the visitor to the state of interest. Many states have more than one data center.

Bureau of Economic Analysis (www.bea.gov)

Regional accounts data is available at www.bea.gov/regional/index.htm. GDP by state and metropolitan area is available, as well as personal income information. The BEARFACTS reports consist of computer-generated narratives for states, counties, and metropolitan statistical areas. The narratives describe an area's personal income using current estimates, growth rates, and a breakdown of the sources of personal income.

State and Local Government on the Net (www.statelocalgov.net)

This is a guide to government-sponsored Internet sites maintained by Hello Metro. State and local links are to servers that are controlled and managed by state or local governmental agencies. They exclude personal sites, neighborhood pages, political advocacy and campaign pages, promotion and travel sites, and Chamber of Commerce sites. Although the State and Local Government on the Net pages are updated frequently, they are not as up to date as the information contained on individual state and local government servers.

State Websites (www.state.xx.us)

Here, "xx" is the two letter state abbreviation. A substantial amount of information can often be obtained from state websites about a local region. Hello Metro (see the preceding section) is a good resource for finding more local (county, city, and so on) government-sponsored websites.

Market Data (Stocks and Bonds)

There may be times when the value of a market index at some date a few years ago is needed, or one would like to include a discussion of stock market trends in his or her report. Rather than save old editions of *The Wall Street Journal*, this information can be obtained online.

Yahoo! Finance (www.finance.yahoo.com)

A variety of market indexes can be retrieved from this site. On the left side of the screen, click the link "Market Data" to see market indexes (up-to-the-minute as well as historical). Individual company stock quotes, mutual fund data, news, interest rates, and much more can also be tracked on this site.

NASDAQ Website (www.nasdaq.com)

This website has data on every stock that trades in the over-the-counter market and is listed in the NASDAQ system. Essentially, these are all of the publicly traded stocks that are not listed on the New York or the NYSE MKT. Available on the website are historical quotes for stocks and mutual funds and dividend information, as well as information about stock splits and the like. Daily, weekly, monthly, and quarterly results are available. There are links to news headlines, global markets, economic releases, and more. The information is all free.

Other Sites

Current and historical stock price information can be obtained from www.bigcharts.com or from www.finance.yahoo.com. There are others as well, but this is a step in the right direction. These sites only provide stock price information for stocks that are currently trading. If data are needed for companies that are no longer trading, the valuation analyst will have to play hide and seek like the rest of us.

Industry Data

The valuation analyst should consider industry data that will generally include information about the competition, the general outlook for the industry (locally and nationally), and special industry situations, such as technological developments and the effect of regulatory activities. The purpose of obtaining industry data is to allow the valuation analyst to make an assessment of how the valuation subject compares with its peers. Determining the strengths and weaknesses of the valuation subject is an important element in the risk analysis and is necessary for the determination of appropriate pricing multiples for the market approach or discount and capitalization rates for the income approach.

One of the best places to start in the search for industry information is a trade organization. These organizations` frequently publish trade journals, gather statistical data about members of the organization, and provide other information that the valuation analyst can use. I have found that people working at trade organizations are generally very helpful.

Books such as Gale Research's *Encyclopedia of Associations*[2] can be found at the local library and provide information on trade associations (Gale's listings can be found online, but there is a fee for this service). The Center for Association Leadership website (www.asaecenter.org) is also a good resource that may be used to find trade organizations. Several Internet sources for trade association information are reviewed later. Some other helpful sources for the industry outlook can be found in box 5.4, and a description of many of these data sources follows. It should be a good way to get acquainted with them.

BOX 5.4 Key Additional Data Sources for Industry Outlook and Financial Information

Industry Outlook

- Standard & Poor's (S&P) industry surveys
- The Value Line Investment Survey
- Brokerage house industry studies
- Regulatory agencies' reports
- Financial publications
- U.S. Industry & Trade Outlook (prior to 2000)

Financial Information

- Integra Information's Business Profiler
- Trade association surveys
- Corporation Source Book of Statistics of Income
- Partnership Source Book of Statistics of Income
- Sole Proprietorship Source Book of Statistics of Income
- Almanac of Business and Industrial Financial Ratios
- Financial Statement Studies of the Small Business
- RMA Annual Statement Studies
- S&P Analysts' Handbook
- D&B Industry Norms and Key Business Ratios

Standard Industrial Classification (SIC) Manual

To find guideline company information, numerous sources are available to consult. Usually, the starting point for this analysis is to determine the subject company's SIC code. Once you know the SIC code for the subject company, various sources that categorize companies in this manner can be consulted. The *SIC Manual* can be consulted if it is unclear which SIC code is appropriate for the subject company. (Exhibit 5.3 contains a sample from this publication.) The *SIC Manual* classifies business establishments by industry, arranging them by the primary activity in which the company is engaged. The code system is used to assist in comparing similar companies within a specific industry. Each individual industry is classified by a major group number, then further classified by an industry group number, followed by an industry number. The industries are arranged in the book in numeric order and in the back of the book in alphabetical order by business classification. The major group, industry group, and industry numbers are explained, and a listing of industries included under each classification number is also given.

The *SIC Manual* is published by the Executive Office of the President, Office of Management and Budget, and is sold by National Technical Information Service, Springfield, Virginia. The publication is revised periodically to reflect the changes within the industrial organization in the economy. The last revision of the *SIC Manual* was in 1987.

If a copy of the manual is not readily available, search for a SIC code and its description online at www.osha.gov/pls/imis/sicsearch.html and use keywords to find what you need.

2 Gale Research, Inc., *Encyclopedia of Associations* (835 Penobscot Building, Detroit, Mich. 48226-4095).

EXHIBIT 5.3 Sample from SIC Manual

Major Group 72.—Personal Services
The Major Group as a Whole

This major group includes establishments primarily engaged in providing services generally to individuals, such as laundries, dry-cleaning plants, portrait photographic studios, and beauty and barber shops. Also included are establishments operating as industrial launderers and those primarily engaged in providing linen supply services to commercial and business establishments.

Industry Group No.	Industry
721	**LAUNDRY, CLEANING, AND GARMENT SERVICES**

7211 Power Laundries, Family and Commercial
Establishments primarily engaged in operating mechanical laundries with steam or other power. Establishments primarily engaged in supplying laundered work clothing on a contract or fee basis are classified in Industry 7218.

Laundries, power: family and commercial
Laundry collecting and distributing outlets operated by power laundries
Power laundries, family and commercial

7212 Garment Pressing, and Agents for Laundries and Drycleaners
Establishments primarily engaged in providing laundry and dry-cleaning services but which have the laundry and dry-cleaning work done by others. Establishments in this industry may do their own pressing or finishing work. Establishments operating their own laundry plants are classified in Industry 7211, and those operating their own dry-cleaning plants are classified in Industry 7216.

Agents, retail: for laundries and drycleaners
Bobtailers, laundry and dry-cleaning
Cleaning and laundry pickup stations, not owned by laundries or cleaners
Press shops for garments
Truck route laundry and dry-cleaning, not operated by laundries or cleaners
Valet apparel service

7213 Linen Supply
Establishments primarily engaged in supplying to commercial establishments or household users, on a rental basis, such laundered items as uniforms, gowns, and coats of the type used by doctors, nurses, barbers, beauticians, and waitresses; and table linens, bed linens, towels and toweling, and similar items. Establishments included in this industry may or may not operate their own laundry facilities. Establishments primarily engaged in providing diaper service are classified in Industry 7219.

Apron supply service
Coat supply service
Continuous towel supply service
Gown supply service, uniform
Linen supply service
Shirt supply service
Table cover supply service
Towel supply service, except wiping
Uniform supply service, except industrial service

7215 Coin-Operated Laundries and Dry-cleaning
Establishments primarily engaged in the operation of coin-operated or similar self-service laundry and dry-cleaning equipment for use on the premises, or in apartments, dormitories, and similar locations.

Coin-operated laundries
Dry-cleaning, coin-operated launderettes
Self-service laundry and dry-cleaning
Laundromats
Laundry machine routes, coin-operated

(continued)

EXHIBIT 5.3 Sample from SIC Manual *(continued)*

7216 Dry-cleaning Plants, Except Rug Cleaning

Establishments primarily engaged in dry-cleaning or dyeing apparel and household fabrics other than rugs. Press shops and agents for drycleaners are classified in Industry 7212; establishments primarily engaged in cleaning rugs are classified in Industry 7217; and establishments primarily engaged in dyeing fabrics for the trade are classified in Manufacturing, Major Group 22.

Clearing and dyeing plants, except rug cleaning
Collecting and distributing agencies operated by cleaning plants
Drapery dry-cleaning plants
Dry-cleaning plants, except rug cleaning

7217 Carpet and Upholstery Cleaning

Establishments primarily engaged in cleaning carpets and upholstered furniture at a plant or on customers' premises. Establishments primarily engaged in rug repair are classified in Industry 7699, and those primarily engaged in reupholstering and repairing furniture are classified in Industry 7641.

Carpet cleaning and repairing plants
Carpet cleaning on customers' premises
Furniture cleaning on customers' premises
Rug cleaning, dyeing, and repairing plants
Upholstery cleaning on customers premises

7218 Industrial Launderers

Establishments primarily engaged in supplying laundered or dry-cleaned industrial work uniforms and related work clothing, such as protective apparel (flame and heat resistant) and clean room apparel; laundered mats and rags; dust control items, such as treated mops, rugs, mats, dust tool covers, and cloths; laundered wiping towels; and other selected items to industrial, commercial, and government users. These items may belong to the industrial launderer and be supplied to users on a rental basis, or they may be the customers' own goods. Establishments included in this industry may or may not operate their own laundry or dry-cleaning facilities.

Clean room apparel supply service
Flame and heat resistant clothing supply service
Industrial launderers
Industrial uniform supply service Laundered mat and rug supply service
Radiation protective garments supply
Safety glove supply service
Towel supply service, wiping
Treated mats, rugs, mops, dust tool covers, and cloth supply
Wiping towel supply service
Work clothing supply service, industrial

7219 Laundry and Garment Services, Not Elsewhere Classified

Establishments primarily engaged in furnishing laundry and garment services, not elsewhere classified, such as the repair, alteration, and storage of clothes for individuals and for the operation of hand laundries. Custom tailors and dressmakers are classified in Retail Trade, Industry 5699; fur shops making fur apparel to custom order are classified in Retail Trade, Industry 5632; and press shops are classified in Industry 7212.

Diaper service
Dressmaking services on material owned by individual customers
Fur garments: cleaning, repairing, and storage
Garment alteration and repair shops
Hand laundries
Laundries, except power and coin-operated
Pillow cleaning and renovating
Repair of furs and other garments for individuals
Reweaving textiles (mending service)
Storage of furs and other garments for individuals
Tailor shops, except custom or merchant tailors

North American Industry Classification System (NAICS) Manual (www.census.gov/eos/www/naics/)

Because having one classification system was not enough, our government decided to join forces with Canada and Mexico to come up with a new system. Those of us old enough to remember experienced this same disaster with the metric system. I think I still have a metric tool set that does not fit anything because our country never adopted the system. Well, this is another one of those questionable brainstorms.

The NAICS system is similar to the SIC system. It is more detailed and is designed to replace the SIC system. The official U.S. NAICS Manual, *North American Industry Classification System—United States*, includes definitions for each industry, tables showing correspondence between current NAICS and 2002 NAICS for codes that changed, and a comprehensive index—features also available on the website. I would not order this manual in print as it is regularly changed. You can download it from the website.

Trade Association Websites

As mentioned, broad industry data is available from the Census Bureau and the Bureau of Economic Analysis. Additional broad data may be available in the *Beige Book* of the Federal Reserve Board. More specific industry data are available through newspapers, magazines, trade publications, and the like. Almost every human endeavor seems to have a trade organization devoted to it. Many of these are listed in Gale's *Encyclopedia of Associations*. The listing gives addresses, phone numbers, contact information, number of staff, publications, and other information, including a website if there is one. Often, a website exists even if it is not listed in Gale's. Once a website is found, you can see what type of information is available through the organization. Sometimes, the information is free; often, there is a charge for a back issue of a publication or a survey.

The Internet Public Library (www.ipl.org/div/aon/)

The Internet Public Library produces a guide to websites of prominent organizations and associations. This website has an excellent collection of links to a number of business and economic sites.

First Research Industry Profiles (www.firstresearch.com)

First Research offers industry reports for more than 900 industry sectors. These reports are updated on a quarterly basis and provide a detailed description of the industry and its drivers, trends, and outlook. A subscription will allow access to all industry reports, or reports may be purchased as needed for $139 each. First Research also offers U.S. state and Canadian province profiles for $99 per report.

Encyclopedia Britannica (www.britannica.com)

This is the online version of the encyclopedia. There is information on a large variety of subjects, but much of it may require updating if the valuation date is fairly recent. The information is easily located and is available for a subscription price of $69.95 annually.

Wikipedia (http://wikipedia.org/)

Wikipedia is a multilingual, Internet-based encyclopedia project operated by the nonprofit Wikimedia Foundation. Wikipedia contains more than 19 million articles in 287 languages. Wikipedia's articles are written collaboratively by volunteers around the world, and the majority of them can be edited by anyone with access to the Internet. Steadily rising in popularity since its inception, it ranks among the top 10 most visited websites worldwide.

LexisNexis (www.lexisnexis.com)

LexisNexis is one of the world's largest providers of online information services. Though not exclusive to business and economics, LexisNexis offers access to a wide range of information useful to the business valuation analyst, including comprehensive research by company, country, demographic focus, market, and industry. This resource provides access to thousands of publications from around the world. There is a cost to this service, and it varies with usage.

ProQuest Dialog (www.proquest.com/products-services/ProQuest-Dialog.html)

This resource is a leading provider of Internet-based information. It was initially completed in 1966 and was the world's first online information retrieval center to be used globally. Dialog is currently owned by ProQuest. Dialog provides access to thousands of authoritative business, scientific, intellectual property, and technical publications. Among the wealth of information available is worldwide company and industry information, including trends, overviews, market research, and more. Full financial information is available at the company level. It can be accessed online with a subscription.

Alacra (www.alacra.com)

Alacra is a subscription-based service that provides access to more than 200 premium databases. Partnering with companies such as Dun & Bradstreet, Factiva, Fitch Ratings, LexisNexis, Moody's, and Thomson Reuters, this database provides a wealth of information about private and public companies.

Financial Benchmarking Data Sources

MicroBilt Corporation's Integra Financial Benchmarking Data

Chapter 6 of this book includes a complete discussion of how to use this database as part of the financial analysis process. This is one of my favorites.

Sageworks

Sageworks aggregates private company financial statements from accounting firms, banks, and credit unions through a cooperative data model. This database is the largest real-time repository of private company financial data in the United States, including close to 2 million financial statements from more than 600,000 private firms. The data spans across 1,400 NAICS industry classifications and can be segmented by time period, geography, annual sales range, industry, and data source. It provides coverage for 70 financial items and ratios.

Almanac of Business and Industrial Financial Ratios

This annually updated publication provides current corporate performance facts and figures for a specific accounting period, summarized from tax return data. This information can be used to make comparisons of specific companies to similar ones in the industry. Two types of tables are given for each industry. Both report the operating and financial information for corporations; however, one reports it including companies with and without net income, whereas the other reports it specifically for those corporations that were operating at a profit.

The book divides each industry into categories according to asset size. For each category, ratios are given for the operating factors (cost of operations, repairs, bad debts, and so on), financial ratios (current ratio, quick ratio, asset turnover, and so on), and financial factors (debt ratio, return on assets, return on equity, and return on net worth), which are also defined in the book for reference purposes. The information supplied in the *Almanac of Business and Industrial Financial Ratios*[3] is beneficial in determining how a company compares with its competition and in what areas improvements need to be made or costs need to be cut.

The industrial sectors that are covered in the *Almanac of Business and Industrial Financial Ratios* include construction, agriculture, manufacturing, mining, communications, transportation, banking, insurance, trade, real estate, holding and investment companies, and electric, gas, and sanitary services.

Risk Management Association (RMA) Annual Statement Studies

This publication consists of composite financial data for a number of industries (including agriculture, wholesaling, contracting, services, manufacturing, and retailing), which are categorized by SIC codes. Common size financial statements and ratios are provided for each industry. Current data for each industry is sorted by sales and by assets, and comparative historical data is provided for both groups. Assets, liabilities, and income data are given with appropriate subdivisions (cash, inventory, payables, sales, and so on), and financial ratios are listed as well. These include liquidity ratios, coverage ratios, leverage ratios, operating ratios, and expense-to-sales ratios. In addition, formulas and explanations of the ratios are provided for a further understanding of their usefulness.

RMA, the publisher of the book, receives its data from sources that submit it on a voluntary basis, not on a randomly selected basis. These sources include banks that have obtained financial statements from companies that are looking to borrow money. Therefore, the data in this particular publication should not be used as

3 The *Almanac of Business and Industrial Financial Ratios* is written by Leo Troy, Ph.D., in association with Prentice-Hall, Englewood Cliffs, New Jersey.

industry guidelines when comparisons are made to other businesses in the industry because there is a possibility that the data may not include all of the necessary information to make an absolute comparison.

RMA *Annual Statement Studies* is updated yearly, and the data it presents for the more recent years is in terms of fiscal years from April 1 to March 31 (for example, 2013–2014). An online version of the RMA *Annual Statement Studies* is available on the RMA website at www.rmahq.org/tools-publications/tools/estatement-studies.

BizMiner's Industry Financial Profiles

BizMiner provides financial benchmarking data for more than 5,500 lines of business. Full income statement and balance sheet information by SIC code is available for 3, 5, or 9 years. Companies within each industry are categorized by size of revenues. BizMiner also provides various financial ratios to test solvency, profitability, debt-related risks, and turnover. In addition to its financial bench-marking product, BizMiner provides market research reports for thousands of industries. These reports are available for each industry at the national and local levels.

Financial benchmarking and industry reports can be purchased individually or accessed with a yearly subscription. Full access to BizMiner's products can be purchased for $1229 per year, but there are other subscriptions available, as well. The cost for a single report can be as low as $89. More information about this data source can be found at www.bvresources.com.

IndustriusCFO Industry Metrics Reports

IndustriusCFO (formerly Fintel) provides industry financial data for more than 900,000 companies (mostly privately held) from more than 2,500 different industry groups. Reports can be searched based on SIC or NAICS codes and further narrowed based on location, size of revenues or assets, age of the firms, and number of employees. The reports provide the latest 4 years of income statement and balance sheet information on a dollar and common size basis. The Industry Metrics reports also provide 16 commonly used financial ratios for analyzing liquidity, asset efficiency, and profitability. Subscriptions are available from $49 to $129 per month IndustriusCFO also offers a Business Analyzer product that is focused on the small business owner, rather than the small business analyst. More information can be obtained at www.industriuscfo.com/.

Key Business Ratios

This publication provides financial information on more than 800 lines of business and can be used for comparing companies in the same industry. The industries covered in the book are arranged numerically by SIC code. For each SIC code, the specific name of the industry that corresponds to the code is given, along with the number of companies in the industry that were surveyed for the determination of the statistical data. The financial information provided for each industry includes current assets, total assets, current liabilities, total liabilities and net worth, net sales, gross profit, net profit after taxes, and working capital, along with solvency, efficiency, and profitability ratios. The financial ratios are given for companies that fall into the upper quartile, lower quartile, and median.

The figures found in this publication can be used as a guideline in determining the financial condition of comparable companies, regardless of whether the company is operating above or below the norms in the industry. In addition to statistical data, the book gives an explanation of the use and meaning of the ratios, along with an explanation of their derivation.

Key Business Ratios is published by Dun & Bradstreet Information Services, a company of the Dun & Bradstreet Corporation. An online version of *Key Business Ratios* can be found at www.mergentkbr.com/.

Compensation Data Sources

Salary Assessor and the Executive Compensation Assessor, two products produced by the Economic Research Institute, contain salary information for more than 6,000 jobs compiled from salary surveys. The information is available online at www.erieri.com. An alternative product is Compustat ExecuComp, which is maintained and offered by CapitalIQ of Standard & Poor's. These are good sources for estimating a reasonable level of executive compensation for a particular industry. More information on Compustat ExecuComp can be found at www.capitaliq.com/home/what-we-offer/information-you-need/qualitative-data/execucomp.aspx.

Industry trade groups frequently conduct compensation surveys, either in conjunction with an industry survey or as a standalone study. Often, a hint of the study will be given on the trade association's website. Most of the studies are available to nonmembers for a fee, so it is worth it to check the website and perhaps call the association's headquarters to ask.

MicroBilt Corporation offers a terrific online product called *Integra Financial Benchmarking Data* (Integra), which provides detailed information on profiling small businesses and private companies. This resource covers more than 4.5 million privately held firms in more than 900 U.S. industries. It is capable of analyzing any size firm or 1 of 13 industry size ranges. See chapter 6 for more details about this product. It is one of my favorites.

Integra gets its information from 32 databases, which makes this product one of the most extensive of its kind. Included in the Integra data is a measure of officers' compensation for any group of companies within an industry and size grouping. Integra will sell you individual reports by SIC code on its website, www.microbilt.com. This is too good to be ignored! (And no, I do not own the company!)

BizMiner's BizBenchmarker product also provides an indication of the level of owners' compensation for each industry and size grouping.

Publicly Traded Guideline Company Data

Another component of the data-gathering part of the assignment is to locate information about comparables. These comparables are also known as *guideline companies*. The business valuation committee of ASA captioned this terminology as a means of differentiating what the business valuation analyst does from what the real estate appraiser does in the application of the market approach. Because real estate appraisers can generally find comparables that are close enough to the valuation subject to use in the valuation process, this terminology seems appropriate. However, business valuation analysts do not enjoy the same luxury of finding other companies that are close enough to be considered good comparables. Instead, we use other companies to provide guidance; therefore, these companies are termed guideline companies.

The Old Days (When the Dinosaurs Roamed the Earth)

When many of us gray-haired, old-timers started in this business, the only manner in which one could get public company data was to go to the library and go from book to book to book. Fortunately, those days are long gone. Therefore, instead of providing the old sources that were included in previous editions of this book, I am going to provide today's stuff.

Finding Publicly Traded Company Information

As will be explained in chapter 9, the guideline company method of developing a conclusion of value involves finding publicly traded companies that are comparable to the one being valued. Perhaps the easiest way to do this is to find a database that is searchable by SIC code. This section provides some additional reference sources that might help in this search.

S&P's Capital IQ NetAdvantage

S&P offers a number of products with which you can search for publicly traded companies. Many of these resources are included under S&P's flagship product called Capital IQ, which contains data on thousands of active and inactive publicly traded companies, including 20 years of historical data, if available. One such resource is NetAdvantage, which delivers a wealth of information to your computer—for a fee, of course.

S&P's NetAdvantage product is a comprehensive online database catering mostly to universities, public libraries, and corporate information centers. NetAdvantage is made up of several components, including the following:

- *Register of Corporations, Directors & Executives.* This directory allows users to search for businesses by industry, obtain background information on executives, and find information on various indexes.
- *Corporation records.* This component provides information on more than 10,000 publicly traded U.S., Canadian, and international companies, including financial statements, profiles, recent news, and shareholder reports.
- *Industry surveys.* S&P provides reports on more than 50 of the largest North American and global industries. Along with these reports, S&P also provides its *Trends & Projections* publication, which provides insight into various macroeconomic topics.
- *Stock reports.* S&P's *Stock Report* product provides qualitative and quantitative analysis on more than 4,000 publicly traded companies.

The NetAdvantage database is available on the Capital IQ website at www.spcapitaliq.com/. This may also be accessible for free at a library.

Mergent

Mergent Online (formerly *Moody's Manuals*) consists of data on more than 25,000 public U.S. companies and their SEC filings, including current and historical annual reports. International company data and annual reports are also available. Access to Mergent Online is available at www.mergentonline.com.

In addition to the online service, Mergent continues to offer a number of former Moody's publications in print format (see box 5.5). Information on Mergent's print products can be found at www.mergent.com/mergent-solutions/academic-corporate-public-government-libraries.

BOX 5.5 Mergent Print Publications

- Industrial Manual and News Reports
- OTC Industrial Manual and News Reports
- OTC Unlisted Manual and News Reports
- Transportation Manual and News Reports
- Public Utility Manual and News Reports
- Bank and Finance Manual and News Reports
- International Manual and News Reports
- Municipal and Government Manual and News Reports
- U.S. Company Archives Manual
- International Company Archives Manual
- Unit Investment Trusts Annual Payment Record and UIT Weekly Reports
- Dividend Record and Annual Dividend Record
- Bond Record and Annual Bond Record
- Industry Review
- Handbook of Common Stocks
- Handbook of NASDAQ Stocks
- Handbook of Dividend Achievers

Value Line Investment Survey

This survey is published weekly in three parts: "Summary & Index," "Selection & Opinion," and "Ratings & Reports." The "Summary & Index" section features a listing of companies alphabetized by company name and shows the price, beta, current price and earnings ratio, estimated dividends for the year, and other stock data for each company. There is also a listing of timely stocks in timely industries and various stock rankings and estimates. In addition, the index to part 3, "Ratings & Reports," lists the industries, the page references to them, and the rankings of each industry's probable performance.

Part 2 of the *Value Line Investment Survey* features articles, graphs, and tables on current economic conditions, the Federal Reserve's actions, stock market conditions, earnings estimates, Federal Reserve data, economic information on the GDP, consumer confidence, home sales and starts, and stock market averages.

Part 3 of the *Value Line Investment Survey* gives an in-depth analysis of each industry listed. Recent developments and actions that have affected the industry are discussed, and statistics and graphs showing both current and historical data are provided. News about the major companies involved in the particular industry is presented, along with stock information, the company's current financial position, quarterly earnings, earnings per share, and dividends. The information provided in the three parts of the *Value Line Investment Survey* can be used in analyzing the economy at specific time periods, analyzing industries, and making comparisons with those companies involved in a particular industry.

The *Value Line Investment Survey* is published and copyrighted by Value Line Publishing Inc., New York. Information is available on the Value Line website at www.valueline.com.

Thomson Reuters

Thomson Reuters maintains a database called Thomson One, which is accessible through an Internet-based interface. The Thomson One database provides access to a number of resources, including Thomson Reuters Institutional Brokers Estimate System (I/B/E/S) and Worldscope, among many others. Subscribers can search for guideline companies, download search results and company details in spreadsheet format, and integrate financial data from the database into any valuation models. Although this database is geared more toward the investment banking side of finance, it is still a powerful resource available to the business valuation analyst. Access to this database requires an annual service subscription.

NASDAQ

NASDAQ's website (www.nasdaq.com) makes information on publicly traded companies available for free. If a publicly traded company in the industry you are studying is known, it can be entered on the NASDAQ home page to obtain a quote. Below the quotes are links to additional information. One link is called "Competitors". Clicking on this link will reveal a list of other publicly traded companies in the same industry as the one originally entered. The search cannot be done by SIC code and must begin with a known company. This may not work well in all situations, but it is an overlooked source of a lot of free information about companies in a given industry. Yahoo! Finance and Google have similar links.

Other Sources

Other financial and descriptive information about public companies can be obtained from Form 10-K, Form 10-Q, Form 8-K, and the annual reports of the guideline company, which are available either directly from the guideline company, the SEC, or through commercial vendors.

Sources of forecast financial data include the following:

- Brokerage houses
- I/B/E/S, available through Thomson Reuters
- *Reuters Estimates Consensus Report*
- Zack's Investment Research
- Bloomberg Financial Markets

Transaction Data

In addition to locating specific guideline company information, the valuation analyst will also be looking for data about mergers and acquisitions in the same or similar industry as the valuation subject's. I will explain more about this in chapters 9 and 10, but first let's find out where you can get merger and acquisition information.

Merger and acquisition data can be obtained from the following sources:

- *The Annual Merger and Acquisition Sourcebook*
- *Mergerstat Review*
- *Mergerstat Control Premium Study*
- Computer databases:
  - The Institute of Business Appraisers Inc.
  - BizComps
  - Pratt's Stats
  - Public Stats
  - Done Deals
  - Thomson Financial
  - CapitalIQ
  - Mergerstat (this is sold by Alacra as well as by others)

Mergerstat Review

This annual publication presents compiled statistics relating to mergers and acquisitions. For the current period, and historically, data on merger and acquisition announcements and purchase prices are presented annually and quarterly. Current transactions that are either completed or pending are also shown, as well as the prices offered and equity interest sought for companies that are in the $100 million category.

The 100 largest announcements in history are featured, as are the largest by industry. The publication also has announcements on mergers and acquisitions for specific industries, including a ranking of the dollar value offered and the number of transactions in each industry. International transactions, divestitures, a transaction, cancellation roster by industry, and acquisitions of privately owned companies are other areas featured in the book. The information provided in *Mergerstat Review* can be used to identify industry guideline companies that were involved in actual transactions. The most widely used application of *Mergerstat Review* is the reporting of control premium data. This is discussed in greater detail in chapter 14.

Mergerstat Review is published by FactSet Mergerstat LLC. More information is available at www.factset.com/data/company_data/mergersreview.

FactSet Mergerstat®/BVR Control Premium Study™ Database

FactSet Mergerstat®/BVR Control Premium Study™ is an online database available exclusively through Business Valuation Resources. This database delivers empirical support for quantifying control premiums, implied minority discounts, and public company valuation multiples. It allows you to quickly search nearly 10,000 transactions that detail up to 57 data points, including the control premium, the implied minority discount, and provides up to 5 valuation multiples for each transaction. In addition, you get free quarterly data summaries in printer-friendly versions as part of your subscription.

A list of the companies that were acquired, in addition to the companies that acquired those companies, is given, along with business descriptions and SIC and NAICS codes. Numerous tables relating to the acquisition are provided and contain such information as the acquisition announcement and closing dates, the value of the deal, the percentage of common stock held by the acquirer before and after the acquisition, the price of the stock per share for various time frames, selected ratios, the specific stock exchange on which the stock is traded, and the nature of the takeover. The *Mergerstat* unaffected price is featured (the common stock price per share that has not been affected by the announcement of the acquisition), as is the *Mergerstat* control premium (found by subtracting the *Mergerstat* unaffected price from the purchase price, then dividing the difference by the *Mergerstat* unaffected price). This database is available at www.bvresources.com.

Other Sources of Data

Access to Newspapers and Periodicals

Many local and regional newspapers publish articles on conditions in an area's economy. Every major city's daily newspaper and many small regional papers now have an Internet site. One such website is the "Mergers, Acquisitions and Divestitures" section of *The New York Times* (http://topics.nytimes.com/top/reference/timestopics/subjects/m/mergers_acquisitions_and_divestitures/index.html). You can use the Keyword search function on this page to search for transactions or trends in the merger and acquisition market. Although you may not find a lot of quantitative data this way, you can usually find out what transactions have taken place.

Here are several other websites that have links to many other publications.

American Journalism Review (AJR) NewsLink (www.ajr.org)

The AJR site has links to thousands of U.S. and foreign newspapers. You will also find links to television and radio stations and newswire services. The publication websites that you find may or may not have an archive feature for older articles, and they may or may not charge a retrieval fee for articles. But you can retrieve current news articles from most of them.

The Internet Public Library (www.ipl.org/div/news/)

This site has a comprehensive listing of newspapers that have websites located in Africa, Asia, Central America, the Caribbean, Europe, the Middle East, North and South America, the South Pacific, and the United States (by state).

You can also browse by title. The Internet Public Library is a public service organization and learning and teaching environment at the University of Michigan, School of Information. Their mission is to provide library services to Internet users.

A reference center is available at http://www.ipl.org/div/subject/www.ipl.org/div/subject/browse/ref00.00.00 that includes links to sciences and technology, reference, education, arts and humanities, health and medical sciences, law, government and political science, computers and Internet, business and economics, social sciences, entertainment and leisure, and associations.

Factiva (www.factiva.com)

Factiva, formerly Dow Jones Interactive, provides access to a multitude of business news and information resources. Factiva provides access to thousands of media, trade, and consumer publications published in 28 languages from nearly 200 countries. Articles go back 35 years and include analyst reports. The top news sources include *The Wall Street Journal*, Dow Jones Newswires, and *The New York Times*.

Additional Data Sources

Hoover's Company Database (www.hoovers.com) contains a great deal of good information about publicly traded companies as well as industries. Most of it is available through a subscription, but a free search can be done for companies by industry type. The search will locate general information about the company for free; more detailed profiles are available to subscribers. The option to search by SIC code is also available to subscribers. These searches can locate both publicly traded and privately held companies.

The most economical method of creating a guideline company group is to use the databases available through NASDAQ or Hoover's. Another site with a lot of free information is www.zacks.com, the home of Zacks Investment Research. A company search can be done by industry type, revealing analysts' reports on companies within the industry group. You will need a Zacks Premium subscription in order to access these reports. Earnings estimates are available for free in most cases. At the other end of the pricing spectrum is Standard & Poor's Capital IQ product, which will provide you with a wide range of financial data.

EDGAR

The Electronic Data Gathering Analysis and Retrieval (EDGAR) database allows free access to SEC filings of publicly traded companies. EDGAR filings are available on the SEC website at http://www.sec.gov/edgar/searchedgar/companysearch.htmlwww.sec.gov/edgar.shtml.

In addition to the SEC site, third-party vendors offer EDGAR data with value-added features such as enhanced searching or more options for a fee. One of these vendors includes EdgarOnline (www.edgar-online.com/).

Several of the databases mentioned here contain earnings estimates. I/B/E/S's earnings estimates are available electronically on its website, www.thomsonreuters.com, for a fee.

Other sources include *Standard & Poor's Earnings Guide*, which contains consensus earnings estimates on thousands of stocks at www.netadvantage.standardandpoors.com. The *Value Line Investment Survey*, mentioned previously, includes at least two years of projected financial statement data for most companies. *Zacks Earnings Forecaster* and *Bloomberg Markets* are other sources. Analysts' reports are available from the major brokerage houses and contain earnings estimates, buy and sell recommendations, and sometimes forecast financial information. *Nelson's Directory of Investment Research* lists the names of analysts and the industries they follow. Some public companies make analysts' reports available to prospective investors.

TagniFi

TagniFi, formerly FetchXL, helps business valuation professionals automate their guideline public company approach with high quality financial statement data, saving dozens of billable hours on every engagement. Their Excel add-in allows the ability to populate spreadsheets within seconds. Simply enter the valuation date and ticker symbols. TagniFi does the rest by populating spreadsheets with financial data that was available on the valuation date. The TagniFi search tool enables searching by keyword, industry, SIC code, or NAICS code. All TagniFi data go through hundreds of quality checks to ensure that the most accurate financial data is being used in the guideline public company approach. In addition, all of their data is fully auditable back to the source filing. TagniFi's monthly plans deliver a flexible and affordable solution for quality financial statement data. What is really cool about this product is the fact that TagniFi will create the link between the valuation analyst's spreadsheet model and its database, so the population of the data is seamless. My staff is so grateful that they do not have to enter data from public filings that I think even they have started to like me!

PitchBook/BVR Guideline Public Company Comps Tool™

This is a product that is similar to TagniFi, brought to us by Business Valuation Resources, a company that every valuation analyst will get to know well. This searchable tool also drastically reduces the time it takes to develop and analyze a set of guideline public company comparables. PitchBook/BVR Guideline Public Company Comps Tool™ delivers all 10-Q and 10-K filings (from EDGAR) and valuation-date-specific public market prices for public comps that match the subject company. A really nice feature of this product is that the valuation analyst can even retrieve full data on delisted companies. Unfortunately, as with many of these types of products, it is not cheap. An annual subscription used to cost about $3,600, but now, access to this database is available for $1,039. A two-day access pass costs $519. Unless the analyst is only going to do one job per year, why not sign up for the annual subscription at this price? Bill it to the client as an out-of-pocket cost. There will be much more about this product discussed in chapter 9.

Stock Quotes

Because part of the pricing multiples that the valuation analyst may use includes the price of publicly traded guideline companies, I thought that it might also be a good idea to provide some sources for gathering pricing information. Historical and current stock prices for any publicly traded company are available on the websites of the New York Stock Exchange and the NASDAQ as well as on Yahoo! and Google. All of these sources are free, so there is no reason ever to pay for this information.

SunGard's MarketMap

If the valuation analyst insists on paying for something that he or she can get for free, this database is available at http://financialsystems.sungard.com/solutions/market-data/market-map. MarketMap includes current and historical security pricing from more than 160 global exchanges and over-the-counter data sources. It also contains exchange rate, dividend, capitalization, and descriptive information about the companies. MarketMap is produced by SunGard Financial Systems.

Finding Acquired or Merged Guideline Companies

There is no limit to the amount of information that can be retrieved if one knows where to find it. The scary part about what I do for a living is not knowing what is out there. I discuss the various databases that are used in chapter 10. Be patient, and you will eventually get there.

Cost of Capital and Betas

Information about cost of capital and betas, topics to be discussed in chapter 13, is available from numerous sources. One can use Value Line projections to produce an estimate of expected returns on the market.[4]

Additional data sources include Standard & Poor's CompuStat, which is perhaps the best source for betas. *Standard & Poor's Stock Reports*, available in print and online, contains descriptive and summary financial

4 David King, "The Equity Risk Premium for Cost of Capital Studies: Alternatives to Ibbotson," *Business Valuation Review* (September 1994): 123–129.

information on hundreds of publicly traded companies as well as on betas. For more information, go online to www.standardandpoors.com/products-services/netadvantage/en/us.

Betas for individual companies are available for free on the NASDAQ website. These betas use the S&P 500 as the underlying index to calculate performance of the market.

I think that I have provided the valuation analyst enough to get started. By now, he or she probably wishes that he or she was finished. The sources of information listed in this chapter are some of my favorites. Surely, once the valuation analyst logs on to the Internet and begin clicking around on things, he or she will find many of his or her own favorite sources. Be wary, though. A person can easily get lost in his or her Internet research. It has a way of drawing anyone in. Good luck and happy clicking!

Information about many of the databases and publications discussed in this section, as well as about others that the valuation analyst may want to become familiar with, is included in appendix 15 as a downloadable resource.

The On-Site Interview

An important part of the data-gathering phase of the valuation engagement is the on-site interview. It is generally a good idea for the valuation analyst to see what he or she is valuing. Interviewing management at the company's facility has several advantages. First, seeing the physical layout of the facility can help the valuation analyst understand such items as the capacity of the plant and the working environment. (Is the place busy or can someone take a nap there?). Management will also feel more comfortable in its own environment. Being at the business location will also make it easier for the valuation analyst to obtain trade journals and other information that may not have been supplied yet.

The person or persons whom the valuation analyst chooses to interview will vary from job to job, but in general, the following interviewees should be considered:

- The client
- The company's officers and management
- The company's accountant
- The company's attorney
- The company's banker

The questions that should be raised at the interview(s) will cover such topics as operations, financial performance, depth of management, competition, history of the company, personnel, suppliers, customers, marketing, legal issues, and capital requirements. In addition, the valuation analyst should not forget to ask the client for any trade journal articles on how to value the client's business. If the valuation analyst does not find it himself, he may be confronted by the client afterward for not using a particular methodology. Exhibit 5.4 contains a monograph published by The Institute of Business Appraisers titled "Questions to Ask When Appraising a Business."

A valuation analyst will generally find that more information is gathered during the management interview than by reviewing the volumes of documents that are frequently gathered. Financial documents rarely tell the entire story. Management should be able to provide the valuation analyst with a good history of the company, an understanding of what made the company's financial results appear the way they do, and expectations about where the company is going. The history could even be written by the client. Sometimes, this information can be obtained by going to the company's website or by going through the company's brochures.

It's terrible to say, but frequently, valuation analysts must take what their own clients tell them with a grain of salt. For example, if the valuation analyst has a client who is going through a divorce, he or she is most likely to get a story of doom and gloom. However, if that same client is looking to sell the business, the future always looks great. The valuation analyst should not lose sight of the purpose and function of the valuation assignment when he or she conducts the interview.

Another practical consideration is whether the valuation assignment is impaired if the valuation analyst does not get to speak to management. It is not uncommon in litigation assignments for the valuation analyst to be prevented from speaking to the company's management. Even if the valuation analyst is allowed to speak to them, they may not be as cooperative as he or she may like. What does the valuation analyst do then? We are all tempted to teach them a lesson, but it is unprofessional and highly unethical to make a point by becoming adversarial. The valuation analyst may also not want to hit them if they are bigger!

EXHIBIT 5.4 Questions To Ask When Appraising A Business

The answers to the following questions should give the appraiser a good base of information about the business he has been asked to appraise.

Not all of these questions will apply to all businesses, nor to all situations. However, many of them will apply in a given situation, and even those that do not apply directly may suggest other information that the appraiser may wish to obtain.

No list of questions about a business can be exhaustive. However, the following questions cover many of the most important aspects of a business that should be scrutinized when the business is to be appraised.

About the Form of Organization of the Business

Is the business a sole proprietorship, partnership, or corporation?

If a partnership:

- How many partners, and who are they?
- Are they all in favor of selling?
- If not, is this likely to be a serious problem?

If a corporation:

- How many stockholders are there?
- Who are the major stockholders, and what percentage of the total outstanding shares does each of them own?
- Are all of the stockholders in favor of selling?
- If not, what percentage of the total outstanding shares is represented by those stockholders who are in favor of selling?
- Are the stockholders who are not in favor of selling likely to be a serious problem?
- Is the stock traded on a market?
- What market?
- What are recent prices for shares traded?

About the Products/Services of the Business

- What are the principal products/services?
- For what length of time has each been sold?
- What has been the sales volume of each, for each of the past 5 years?
- What are the (a) costs and (b) gross profit for each of these products/services?
- What portion of the total cost is for materials?
- What portion is for labor?
- What portion is for overhead?
- Which of the products/services are proprietary?
- Which products are purchased from others, for resale?
- What is the nature of the agreement(s) with the supplier(s) of these products?
- What features of the business' products/services distinguish them from competition?
- What product/service warranties are given to customers?
- What is the forecast of future sales and profits for each major product/service?
- How do quality and price compare with similar products/services offered by competitors?
- To what extent does the business rely on the services of outside vendors or subcontractors?
- Who are the principal vendors/subcontractors?
- What other products/services could be produced/furnished with the existing facilities?

(continued)

EXHIBIT 5.4 Questions To Ask When Appraising A Business *(continued)*

About Markets and Marketing

- What are the principal applications for each major product/service?
- What are the principal markets for each major product/service?
- To what extent are these markets already established, and to what extent must they still be developed?
- What is the future outlook for growth, or lack of growth, of each of these markets?
- Who are the principal customers?
- What portion of the total sales volume does each of these customers represent?
- Which major potential customers have not yet been secured as actual customers?
- How do sales break down geographically?
- What is the present backlog for each major product/service?
- How has this backlog varied over the past 3 years?
- Who are the principal competitors?
- What are the relative strengths and weaknesses of each of these competitors?
- What is the estimated sales volume of each of these competitors?
- What is this business' relative position among its competitors with regard to sales volume?
- What is its relative position among its competitors with regard to reputation?
- Has the business' past sales growth generally followed the industry trend, or has it been ahead of or behind this trend?
- What is the forecast of future industry-wide sales for each of the business' products/services?
- What is the forecast of this business' future sales for each major product/service?
- Does the business regularly use the services of any advertising and/or public relations firms?
- Who are they?
- Is the marketing aggressive and skillful?
- Who is responsible for market research?
- Who is responsible for advertising and sales promotion?
- Who is responsible for product applications?
- Who is responsible for exploiting new markets?
- What is the nature of the direct selling organization (supervision, personnel, field offices, salary and other compensation)?
- What is the nature of the distributor and/or sales representative organization (list of distributors/sales representatives, exclusive or non-exclusive nature of agreements, expiration dates of individual appointments, past performance of each distributor/representative, commission and/or discount rates, contract terms)?
- What is the nature of the service organization (who is responsible for service, installation, maintenance, etc.)?
- Are there any foreign operations?
- Details?
- Does the business use the services of any outside consultants for market research or similar activities?
- Who are they?
- What is their past record of accomplishment?
- How are they compensated?
- Are any of them under contract?

About the Financial Situation of the Business

- What is the sales and earnings record of the business for each of the past 5 years?
- What salaries/dividends have been paid to owners/stockholders during each of the past 5 years?
- Are income/expense statements available for each of the past 5 years?
- Is a current balance sheet available?
- What are the details of the accounts receivable (from whom receivable, amounts, age, etc.)?
- What about inventory?
- What is normal inventory level?
- What is the actual inventory at present?
- How does this inventory break down among raw material, work in process, and finished goods?
- What is the condition (new, obsolete, damaged, etc.) of the existing inventory?
- Is any portion of the inventory on consignment?
- What portion?

EXHIBIT 5.4 Questions To Ask When Appraising A Business

About the Financial Situation of the Business *(continued)*

- Consigned to whom?
- For how long?
- On what terms?
- What are the details of the accounts payable (to whom payable, amounts, age, any special circumstances, etc.)?
- What loans are outstanding, to whom are they payable, and what are the terns of each loan (interest rate, payment schedule, collateral, etc.)?
- What is the amount of accrued expenses payable?
- What items does this include?
- Are all federal and state taxes (including employee withholding taxes) current?
- What is the present book value (net worth; invested capital plus retained earnings) of the business?
- What is the amount of available working capital?
- What is the business' depreciation policy for fixed assets?
- What overhead (burden) rates are used in determining costs?
- What are the various departmental budgets?
- What is the advertising and sales promotion budget?
- What is the total payroll?
- Does the business own equity in any other businesses?
- What liabilities, contingent or otherwise, exist in connection with product/service warranties?
- Are there any existing claims and/or known contingent liabilities of any nature whatsoever?
- Details?
- Are there any contract disputes or renegotiations pending?
- Are there any outstanding stock options, convertible notes, or the like?
- Is there an existing forecast of future sales, profits, and capital requirements?
- What does this forecast show?

About the Physical Facilities

- Is a complete list of physical facilities and equipment available?
- Is the real estate owned or leased?
- If owned, what is the appraised value?
- When was this appraisal made?
- By whom?
- If leased, what are the terms of the lease (period, rental, security deposit, restrictions on use of premises, renewal options, etc.)?
- What are the zoning restrictions?
- Are any of the other physical facilities or equipment leased rather than owned?
- Details?
- Is there any excess or idle capacity?
- How much?

About Personnel and Organization

- Is a complete organization chart available?
- Are position descriptions available?
- What are the functions of key executives and personnel?
- What is the total personnel complement?
- Are there established rates of pay or pay ranges for the various jobs?
- How do these rates compare with those of other employers in the general area?
- What is the wage and salary review policy?
- What employee benefits exist (life insurance, hospitalization insurance, vacation, sick leave, pension, profit sharing, etc.)?
- Is the cost of these benefits paid entirely by the business, or do the employees contribute part of the cost?

(continued)

EXHIBIT 5.4 Questions To Ask When Appraising A Business *(continued)*

- What part?
- Are the workers unionized?
- Which ones?
- What are the contract details?
- Have there ever been any unsuccessful attempts to organize the workers?
- Details?
- Have there ever been any strikes?
- Details?
- What has been the experience with respect to employee turnover?
- Are the employees given any formal training for theft jobs?
- Details?
- Is there a house organ, employee bulletin, or newsletter for employees?
- Details?
- Are written personnel policies and/or procedures available?
- What is the general situation in the area with regard to availability of labor?

About Management

- Is an organization chart available?
- What are the backgrounds of key members of management?
- What is the compensation of key members of management?
- Are any members of management (or any other employees) under contract to the business?
- Details?
- Will the sale of the business involve or require any substantial reorganization of management?
- How is it regarded by its bank(s), and by the financial community in general?
- How is it regarded by its employees?
- How is it regarded by the community in which it is located?
- Has the business or any of its principals ever been found guilty, or ever entered a plea of no contest or been a party to a consent decree, with regard to anti-trust laws, anticipation regulations, securities laws or regulations, or the like?
- Details?
- Has the business complied with applicable requirements of the Occupational Safety and Health Administration (OSHA) to the satisfaction of the cognizant OSHA office?
- What has been the past history of the business with regard to litigation?
- Is the business involved in any joint ventures or similar undertakings?
- Details?
- What are the business' major accomplishments?
- Where has the business failed to an appreciable degree?
- Which members of management can be expected to remain with the business following the sale?
- What are the management capabilities of the persons in charge of each of the key departments?
- How well is each of these departments staffed?
- How capable is the second echelon of management?
- Are there any strong differences of opinion among members of management?
- Details?
- Do separate departments cooperate willingly and effectively with each other, or are there cases where cooperation is grudging or non-existent?
- Is management progress-minded and willing to take reasonable risks?
- Who dominates the organization?
- If the business is a corporation, what control do major stockholders exercise over the company's policies and/or activities?
- Are there any proxy fights, or attempts by outsiders to take over control of the company?

EXHIBIT 5.4 Questions To Ask When Appraising A Business

About the Business in General

- When was the business established?
- For how long has it been owned by the present owner(s)?
- Does success of the business depend to an unusual degree on the capabilities, performance, and/or contacts of one or more key persons?
- Details?
- What potentially dangerous situations exist, or might arise, in connection with the business' management, products, services, markets, finances, facilities, legal obligations, etc.?
- How is this business regarded by its customers?
- How is it regarded by its competitors?
- How is it regarded by its suppliers?
- How is it regarded by cognizant government agencies?
- How is it regarded by its bank(s), and by the financial community in general?
- How is it regarded by its employees?
- How is it regarded by the community in which it is located?
- Has the business or any of its principals ever been found guilty, or ever entered a plea of no contest or been a party to a consent decree, with regard to anti-trust laws, anti-discrimination regulations, securities laws or regulations, or the like?
- Details?
- Has the business complied with applicable requirements of the Occupational Safety and Health Administration (OSHA) to the satisfaction of the cognizant OSHA office?
- What has been the past history of the business with regard to litigation?
- Is the business involved in any joint ventures or similar undertakings?
- Details?
- What are the business' major accomplishments?
- Where has the business failed to an appreciable degree?

In a situation in which the valuation analyst is prevented from getting information from management, he or she must determine if the missing information will prevent him or her from being able to give an unqualified conclusion of value. One of the limiting conditions in the report will be something like this:

> This valuation was conducted without the benefit of management's cooperation. We were not allowed to interview management. If we had been allowed to interview them, we might have discovered information that may have affected our conclusion of value.

This is called "protect thyself!" The last thing that the valuation analyst wants sprung on him or her are questions like "How come you didn't speak to management?" or "How come you did not know that the company was planning to file for bankruptcy?" or "Wouldn't your answer be different if you knew that 82 percent of the company's sales came from one customer?" An answer like "Of course it would" doesn't bode well before a judge or jury. Of course, they may laugh inside because they know that the valuation analyst is right.

In litigation engagements, the valuation analyst can and should request that a deposition of the management personnel be taken if they won't cooperate with the management interview. The valuation analyst can provide the client's attorney with all the questions that the he or she wants the attorney to ask. The questions should generally be as detailed as possible in order to get a full response. This is because the person being deposed, if prepared for the deposition, will give a lot of "Yes," "No," and "I don't remember" types of responses. The attorney asking the questions should be provided with an understanding of what the valuation analyst is trying to achieve. If permitted, the valuation analyst may even sit in the room while the deposition is taking place. Then, if there are additional questions that must be asked to clarify some of the answers given, the analyst can write them out and hand them to the attorney asking the questions.

Conclusion

Now that you have finished this chapter, you should have a better idea about the data-gathering process. You should also be more familiar with many of the data sources that will be needed to do the valuation. At this point, you should also be familiar with the on-site interview. If not, reread this chapter before going any further.