

KTS, INC.

VALUATION ISSUES™

KLARIS, THOMSON & SCHROEDER, INC.

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Featured Article

REVIEW OF THE DAVIS CASE PART TWO OF THREE

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The Davis Case (Part Two of Three)

Relative to the Featured Article (Davis Case Part One of Three) in the Klaris, Thomson & Schroeder, Inc. ("KTS") Newsletter sent in the beginning of this year, KTS will discuss part 2 of 3 on the Davis Case. In this newsletter we concentrate on the issue of blockage.

The issue of blockage (blockage discount) was raised by the taxpayer in the Davis Case relative to the shares of Winn Dixie Stock, held by A.D.D. (the holding company). For

purposes of this article and the Davis Case, blockage is defined as a "discount (or premium) applicable to a publicly traded stock because the size of the block being valued is large enough that it could affect the market price if and when the shares were sold in the public market." The effect could be positive if the block could command a premium and negative if the block would warrant a discount based on market forces.

In the Davis Case the following blockage discounts were opined by the three experts:

Taxpayer Expert #1 – Howard: 2.5% in his appraisal report 4.9% in his rebuttal report

Taxpayer Expert #2 – Pratt: 10.0%

IRS Expert – Klaris, Thomson & Schroeder, Inc. (John A. Thomson, ASA, MAI): 0%

In the Davis Case, we are analyzing a block of stock of 1,020,666 shares of Winn Dixie, a publicly traded stock on the New York Stock Exchange. This block of shares represented approximately 1.33 percent of the total outstanding shares.

Traditionally, one of the main arguments advanced by the federal government against blockage is that it is unfair to tax a person who owned large amounts of stock at a lesser rate than a taxpayer who owned small amounts of stock.

It should be remembered that blockage is not a rule of law, but a question of fact. The following is a partial list of factors that should be considered in opining on the applicability of a blockage discount, and the size of the discount if applicable.

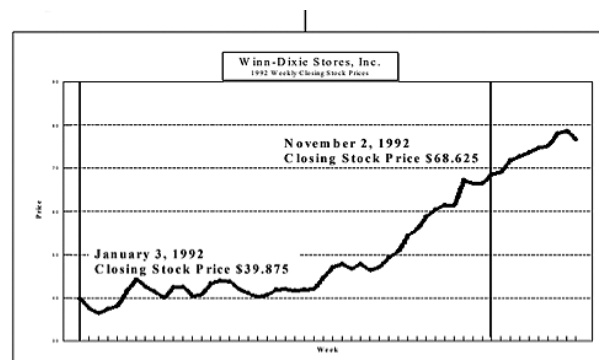
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1. Size of the block.
2. Trading price and trend in the trading price at the valuation date.
3. Trading activity including volume of shares traded and any correlated effect on price.
4. Financial condition and performance of the Company.
5. The economic outlook as of the date of valuation.
6. The stock yield and/or its dividend history and outlook.
7. The class of stock and the exchange on which it trades.
8. Float – total shares trading in the public market.

Taxpayer Expert #1, Mr. Howard's 2.5 percent initial discount was based on the placement, a private placement which would always indicate a discount. His second opinion of 4.9 percent was based on the Black-Scholes Model – a model criticized by the second taxpayer's expert in one of his books. This model would always produce a cost, thus a discount. Taxpayer Expert #2, Mr. Pratt, opined to a 10 percent discount. However, the Judge had the following to say about Mr. Pratt's opinion:

"Mr. Pratt did not explain in his expert report, as required by Rule 143(f), how he arrived at a 10 percent blockage and/or for SEC Rule 144 discount, and we did not find his limited explanation in his rebuttal report and at trial of how he determined the amount of that discount to be particularly helpful. On the record before us, we shall not rely on Mr. Pratt's opinion."

KTS (Mr. Thomson) provided three graphs and a table relative to the share price trends and volume of the subject stock as of the valuation date, one of which is shown to the right: (Price Trend).



This is what the Judge referred to as a "rising trend line."

Additional factors cited in the KTS report were:

- (a) Return on equity for Winn Dixie climbed each year to a record high of 21.6 percent as of the valuation date of November 1992.
- (b) Fiscal year 1991 (the year prior to the valuation date) was the 57th consecutive year of sales growth for Winn Dixie.
- (c) "Increases in dividends paid over a record number of years exemplifies the overall strength of Winn-Dixie" (Value Line Source).
- (d) "Based on performance, your board, in July, voted to increase monthly cash dividends by 10%. This is our 49th consecutive year of dividend increases, as we continue to hold the New York Stock Exchange record" (Message to shareholders 1992 Annual Report).

The facts and circumstances in this case and in our opinion and the opinion of the court did not warrant any blockage discount.

In our next issue KTS will cover the marketability discount including how we quantified our 15 percent built-in capital gains consideration. □



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"Strive not to be a success, but rather to be of value." Albert Einstein

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