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VALUATION ISSUES™

Klaris, Thomson & Schroeder, Inc. **2000-1**

The Davis Case
Part Two of Three

by John A. Thomson, ASA, MAI

IN THIS ISSUE...

In part 2 of 3 on the Davis Case 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	Taxpayer Expert #2 Pratt	IRS Expert KTS (Thomson)
2.5% in his appraisal report 4.9% in his rebuttal report	10%	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 was that it was basically 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.

> **"It should be remembered that blockage is not a rule of law, but a question of fact."**

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.

Mr. Howard's 2.5 percent initial discount was based on the cost of 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 taypayer's expert in one of his books. This model would always produce a cost, thus a discount. The Taxpayer's second expert 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

Continued Page 2

THE DAVIS CASE (Cont.)

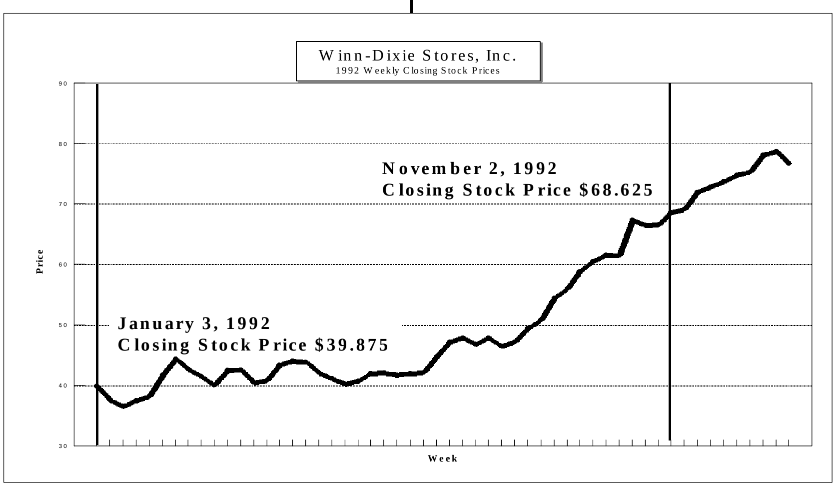
he determined the amount of that discount to be particularly helpful. On the record before us, we shall not rely on Mr. Pratt's opinion."

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

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 below: (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 we will cover the minority interest discount (stipulated to) and the marketability discount including how we quantified our 15 percent built in capital gains consideration.

John A. Thomson, ASA, MAI *is a Managing Director with* **KTS, Inc.**, *in the Los Angeles Regional office and is a Senior Member of the American Society of Appraisers (ASA) and a Member of the Appraisal Institute (MAI). (562) 597-0821 e-mail: jthomson@ktsvaluation.com*

Valuation of Government Contractor Companies

by

Ronald A. Stramberg, ASA

Part 1 of 2

As a business valuation expert in the Washington, D.C. area, I have been engaged in the valuation of over 20 government contractor companies in recent years, many of which are headquartered around the Beltway. From a business valuation standpoint, these companies are different in a number of perspectives than other commercial businesses.

First, and foremost, the future revenues of a government contractor company are many times less predictable than other commercial concerns, since they are often tied to a few large contracts, which may or may not be extended, expanded, or replaced. An additional factor to consider is the company's status, as a government contractor. Does the company have preferential status with respect to government contracts as an 8(a) contractor? Will the company lose that preferential treatment in the future, as a result of graduation from the 8(a) program, due to growth in operations.

Because the future revenues of government contractor companies are generally more difficult to predict than those of other commercial concerns, and often times tied to a few large contracts, there is typically more risk in achieving those projections, which is reflected in higher discount rates used to determine the present value of the projected net cash flows.

In general, another significant difference between government contractor companies and other commercial concerns is the consistency of financial performance. In my experience, I have found that government contractor companies typically have less consistent and

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Valuation of Government Contractor Companies
(Cont.)

more erratic financial performance than other commercial concerns. As a result, in the valuation of a government contractor company, (through utilization of the market approach) it is much more appropriate to apply price multiples to three or five-year average financial measures than the results from a single year.

Listed below are some recent government contractor company engagements.

1) Contemplation of the sharing of stock ownership with employees through an ESOP (Employee Stock Ownership Plan) or an ISOP (Incentive Stock Option Plan).

2) Evaluating an offer received to purchase a company.

3) The gifting of minority interest common stock to members of the founder's family.

4) The redemption of common stock from former employees.

5) To establish a value for a buy-sell agreement.

6) Setting a price at which to sell off an unprofitable subsidiary.

Many of the above-noted transactions (i.e., ESOP, ISOP, gifting of stock) necessitate a detailed report on the value of the company due to government regulations that cover those situations. In other situations though, (i.e., to evaluate an offer to buy the business) a less in-depth report would suffice. Regardless of the manner in which the valuation is reported, there are generally accepted methods used to value the government contractor business and its underlying stock.

First, before the valuation is undertaken, there must be a clear understanding of: (1) the intended use of the valuation; (2) the ownership interest to be appraised; and (3) the applicable valuation date. The reasons why these factors must be delineated prior to undertaking the valuation is because they may impact the result. For example, if the intended use of a valuation of company stock is for an ESOP, the opinion of value must be "fair market value," as opposed to other value measures (i.e., "fair value" or "investment value") and the unique aspects of the marketability of ESOP stock must be considered.

> **"...if the intended use of a valuation of company stock is for an ESOP, the opinion of value must be "fair market value."**

The size of the ownership interest to be appraised (i.e., minority interest versus controlling interest in the company's common stock) and the features of the stock (i.e., voting privileges, dividends, etc.) are also important elements that impact the results of the valuation. These elements impact the methods used to perform the valuation (i.e., merger and acquisition method versus guideline company method) and the application of discounts or premiums. Since the marketplace for government contractors and other types of businesses is dynamic and changes over time, due to changes in the economy, government budgets, etc., business/stock valuations are prepared as of a specific date and are generally only relevant for a short period of time.

In the next issue we will discuss the selection and application of methodologies contained in the approaches used to value government contractor companies.

__Ron A. Stramberg, ASA__ is a Vice President with **KTS, Inc.**, *in the Washington, D.C. Regional office and is a Senior Member of the American Society of Appraisers. (301) 881-8360 e-mail: rstramberg@ktsvaluation.com*

St. Louis Office Adds to Professional Staff

Klaris, Thomson & Schroeder, Inc. is pleased to announce that Luke A. Waller, MBA, has joined the company in our St. Louis Area Office.

Mr. Waller specializes in the valuation of equity interests in closely held businesses and partnerships for estate/gift tax, ESOP, litigation support and other purposes in many different industries.

KTS St. Louis Office Moves to Metroeast Location

Our St. Louis market continues to grow and expand, as has our staff. To accomodate this growth we have moved to larger offices.

Our new St. Louis area address is:

220 Bradford Lane, Suite A
Waterloo, Illinois 62298
Phone: (618) 939-5255
Fax: (618) 939-5256

For the convenience of our St. Louis clients we have kept our St. Louis mailing address and phone numbers which are:

P.O. Box 515118
St. Louis, Missouri 63151
Phone: (314) 739-1000
Fax: (314) 739-1441

KTS CALENDAR

RECENT AND UPCOMING SEMINARS AND SPEAKING ENGAGEMENTS

11/15/99	Presentation—Bryan Cave LLP, St. Louis, MO.—"Advanced Valuation Issues"
11/15/99	Presentation—Mathis, Marifian, Richter & Grandy, Ltd., Belleville, IL.—"Business Valuation Issues"
11/16/99	Presentation—Armstrong, Teasdale, Schlafly & Davis, St. Louis, MO.—"Business and Partnership Valuation Issues"
11/17/99	Presentation—Dankenbring, Greiman, Osterholt & Hoffmann, P.C., St. Louis, MO.—"Advanced Valuation Issues"
11/18/99	Presentation—Blackwell, Sanders, Peper, Martin, LLP, St. Louis, MO.—"The Davis Case"
1/12/00	Presentation—Business Valuation Roundtable, St. Louis, MO.—"Fairness Opinions"
3/15/00	Presentation—Central Illinois Estate Planning Council, Decatur, IL.—"Valuation Issues in Estate Planning "

KTS RECENT ENGAGEMENTS

* Fairness opinion for publicly traded internet company on the acquisition of a closely held internet company.
* Opinion of value and direct damage on a start-up telecommunications company damaged by the termination of a large contract.
* Appraisal of the fair rent of a spa and hot springs.
* Appraisal of a special purpose real estate building in downtown Los Angeles; The L.A. Mart.
* Valuation of the common stock of a specialty retailer.
* Appraisal of a split-pay subordinated note.
* Valuation of a large electrical contractor for estate tax purposes.
* Valuation of restricted stock of an internet company prior to going public.

KLARIS, THOMSON & SCHROEDER, INC.

is a full service valuation and consulting company specializing in business valuations, financial consulting, expert testimony and litigation support. In addition we also perform real estate valuations, machinery and equipment valuations, and international transfer pricing analyses.

For more information or for a free valuation seminar for your firm or professional group, please call John Thomson at (562) 597-0821.

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"You never really lose until you quit trying."

- Mike Ditka