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VALUATION ISSUES™

Klaris, Thomson & Schroeder, Inc. **2000-2**

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The Davis Case
Part Three (A) of Three

by John A. Thomson, ASA, MAI

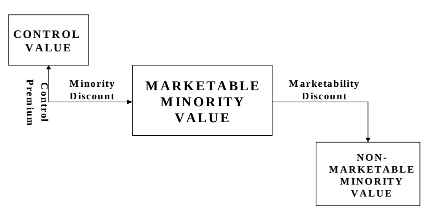
In part 3 of 3 on the Davis case, we concentrate on the issue of minority and marketability discounts including consideration for built in capital gains tax. We have decided to cover this topic by splitting it into part 3A (minority discount) in this issue and part 3B (marketability discount and built in capital gains) in the next issue. The minority discount is a discount for lack of control; however, the degree of control or lack of control will vary with the size of the interest and the dispersion of the remaining interests among other factors. In the Davis case, after the two gifts were made by the father to his two sons, there were three shareholders. Artemus Davis, the father, now owned 48.46 percent; Robert Davis, a son, owned 25.77 percent; and Lee Davis, the other son, owned the remaining 25.77 percent block of stock. The subject of the valuation was the two 25.77 percent blocks of stock gifted by the father to the two sons.

The two appraisers retained by the taxpayer opined to minority discounts of 15 percent (Mr. Howard) and 20 percent (Mr. Pratt). Klaris, Thomson and Schroeder, Inc. was retained by the Internal Revenue Service and opined to a 12 percent minority discount. After five hours of heated discussion among the experts behind closed doors, it was finally agreed to stipulate to a minority discount of 15 percent. Because the discount was stipulated to, there was no discussion of the discount in the court's opinion. However, we thought a few comments would be helpful in understanding its deviation.

In the Davis case after the gifts were made no shareholder (of which there were only three) could control the company.

The chart below shows the three levels of value; control, marketable minority (same as publicly traded stock), and non-marketable minority value.

VALUE INDICATIONS



Some of the attributes or benefits of control are as follows:

1. The ability to change the entity's operating structure;
2. The ability to appoint managers of the entity and set their compensation;
3. The ability to liquidate, dissolve, merge, acquire or distribute assets of the entity;
4. The ability to recapitalize the entity;
5. The ability to declare and pay distributions; and
6. The ability to control the policies and direction of the entity.

In the Davis case, after the gifts were made, no shareholder (of which there were only three) could control the company. Also any two of the three shareholders could combine to control the company. We thought this gave more influence (less lack of control) to each of the gifted blocks as each now represented a swing vote block. The taxpayer's experts disagreed with this, stating that they were all family members and no family member would join with a hypothetical buyer of the other block to control the company. We respectfully disagreed with this position.

All three experts used closed-end funds as their source of market data to help quantify the magnitude of the minority discount. Closed-end funds sell a limited number of shares and invest the proceeds in marketable securities. Unlike open-end funds, closed-end funds generally do not buy their shares back from investors who wish to cash in their holdings. Instead, fund shares trade on a stock exchange. The Net Asset Value (NAV) for a closed-end fund represents the total market value of all of the securities held by the fund less the liabilities. The prices that shares of these funds trade at are usually below the NAV per share. This discount is normally due to the lack of control that the investor has over the various securities owned by the closed-end fund. If the investor

Continued Page 2

THE DAVIS CASE (Cont.)

owned the securities outright, he could control when to sell them or when to buy more shares. In addition, he would control the investment of any proceeds. For this lack of control, investors will normally not buy closed-end fund shares at their net asset value per share, but instead buy these shares at a discount. Since the shares are traded on an exchange, this discount does not represent any discount for the lack of marketability of these shares.

In the end the three experts agreed to stipulate to a 15 percent minority interest discount which was partly motivated by fear of Judge Chiechi's wrath if we did not stipulate to something.

Although all three experts used closed-end funds, the taxpayer's two experts utilized dual funds whereas KTS used general equity funds. Dual funds have one portfolio, but two classes of stock-income shares and capital appreciation shares. Each class usually puts up 50 percent of the fund's total capital, and, in return, receives 100 percent of either the income or appreciation. Whereas shareholders in general equity funds receive their pro-rata share of both income and appreciation which is normal for most companies including the subject company.

The taxpayer's experts only utilized the capital appreciation side of the dual fund (of which there were four) reporting discounts of 31.78, 21.97, 7.65 and 13.82 percent. However, they left out the income side of which all traded at premiums of 20.75, 29.79, 2.54 and 16.48 percent. The median of the four dual funds, when both the income and appreciation were considered, was a discount of 2.5 percent.

The general equity funds (utilized by KTS) of which there were 20, had 14 which traded at discounts from their NAV and six which traded at premiums. A shareholder in a general equity fund receives both income (when and if dividends are declared) and capital appreciation when and if the stock appreciates and is sold. The premiums can generally be disregarded as they are usually a result of a new or novel fund, or superior management. Of the 14 general equity funds trading at a discount, the mean was 9.82 percent and the median was 6.87 percent. KTS used 10 percent as a starting point and adjusted for certain relevant factors: (1) portfolio diversification; (2) value line rating; (3) size of block-potential swing and (4) cattle operation/ dividend history. Our adjustment was upward for factors 1 and 4 and downward for factors 2 and 3. Overall, we adjusted our 10 percent base discount up by 20 percent to 12 percent. The taxpayer's experts gave little explanation in their reports on how they arrived at their minority discounts of 15 and 20 percent.

Therefore, the basic disagreements over the minority discount were over two issues: first, the size of block and swing vote potential, and, second, the use of only half of the dual equity closed-end fund versus general equity closed-end funds as a starting point.

In the end, the three experts agreed to stipulate to a 15 percent minority interest discount which was partly motivated by fear of Judge Chiechi's wrath if we did not stipulate to something.

We should point out that A.D.D. (the subject company) also owned a small block of shares of D.D.I (which owned 22 percent of Winn Dixie). KTS in the same report valued this block of stock using a 15 percent minority discount. The difference being primarily the smaller size of the block of stock (less than one percent), and the lack of a swing vote potential.

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Valuation of Government Contractor Companies

by
Ronald A. Stramberg, ASA
Part 2 of 2

In part 1 we discussed some of the factors which make government contractor companies unique from other companies. In part 2 we discuss the methods that are used to value government contractor companies.

The valuation of a government contractor company and its underlying stock is determined by the selection and application of methodologies contained within three general approaches to value: market, income, and cost.

The first category, market, is a general way to determine a value indication of a company's common stock using one or more methods that compare the common stock in the company under appraisement to the stock of similar businesses that have been sold. Examples of the market approach include the Guideline Company method and the analysis of prices paid for similar companies in the merger and acquisition marketplace.

The Guideline Company method requires an investigation and analysis of publicly-traded companies similar to the company under appraisement, with regard to type of products/services provided, financial performance, etc. Examples of publicly-traded government contracting companies investigated for use as guideline companies in the valuation of private government contracting companies include the following: Advanced Communication Systems, Inc.; BTG, Inc.; CACI International, Inc.; Comarco, Inc.; GRC International, Inc.; GTS Duratek, Inc.; Government Technology Services, Inc.; Maximus, Inc., and OAO Technology Solutions, Inc., among others. Market multiples for the publicly-traded guideline companies are determined based on the ratio of the price of their stock to various parameters, such as earnings, cash flow, or revenues. In selecting market multiples for the company under appraisement, the

Valuation of Government Contractor Companies (Cont.)

appraiser considers the relative financial condition and operating performance of the company in comparison to the publicly traded guideline companies. Adjustments to these market multiples are considered to reflect the differences between the company under appraisement and the normally larger, publicly-traded companies. Premiums or discounts are applied to the values derived by application of the market multiples to reflect the differences in the level of ownership (minority versus majority) and marketability.

Meanwhile, the merger and acquisition method involves deriving indications of value for the company under appraisement from prices at which entire companies in similar lines of business have been sold or the prices at which significant interests in similar companies changed hands. The general notion of the merger and acquisition analysis is the same as the guideline public company analysis, i.e., the price at which the transaction took place is related to fundamental variables that affect the value. There are various sources from which this information, if available, is obtained, including business brokers, public filings, merger and acquisition databases, etc.

The second general category of value determination, income, requires that the earnings capacity of the company under appraisement be investigated and the resultant indicator of expected earning capacity, whether it is derived from past, current, or projected earnings, be capitalized at a rate sufficient to satisfy the investment and business risk requirements of ownership. The application of this approach usually requires a sufficient earnings history to help give a clear indication of expected future performance. The income approach considers the company's future revenues and its earning potential, along with its estimated capital requirements. The income approach is typically applied in the form of a discounted cash flow analysis. Application of the discounted cash flow analysis, normally entails the projection of revenues, expenses, earnings and cash flows, on an after-tax basis, which are then discounted to their present value.

Once a value is determined discounts may be necessary to reflect any lack of control and/ or lack of marketability of the subject interest being appraised.

Application of the income approach to the valuation of the common stock of a government contractor, through the discounted cash flow analysis, begins with the projection of revenues for the company five or ten years into the future. The projection of future revenues should consider the company's historical revenue levels, its backlog of contracts as of the valuation date, the overall economy, government budgets, as well as, other relevant factors. The discounted cash flow analysis also entails the forecasting of the company's future expense levels, as well as, its capital requirements for fixed assets and working capital. These forecasts are generally developed based upon an analysis of the company's history and those of other similar companies, such as the publicly traded government contractors noted above. The estimated future cash flows of the government contractor company are then discounted to present value through utilization of a discount rate (risk adjusted rate of return) that reflects the perceived risk of achieving those projections. For example, if the projections for the government contractor company under appraisement were principally based on existing government contracts and the contract backlog in place as of the valuation date, the risk would be lower, and that factor would be reflected in a lower discount rate and, consequently, a higher overall value. Once a value is determined, discounts may be necessary to reflect any lack of control and/or lack of marketability of the subject interest being appraised.

The third category of value determination, cost, involves a consideration of the net book value, adjusted book value, or estimated liquidation value of the company under appraisement. Usually, the most recent balance sheet statement at or close to the appraisal date is utilized. Net book value considers only historical costs and, as a result, is not considered a reliable indicator of the fair market value of the common stock of a government contractor, the value of which is principally impacted by current and future revenues and earnings. As such, the cost approach to valuation is rarely, if ever, used to value the common stock of a government contractor.

A final value conclusion for the government contractor company and its underlying common stock is estimated by comparing the value indications developed through application of the market approach and the income approach. Based on the judgement of the business valuation expert, a final value is developed.

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IRS Publishes Final Regulations for "Adequate Disclosure" of Gifts

On December 3, 1999 the IRS published final regulations for Adequate Disclosure of Gifts. The Internal Revenue Code Section 6501(c)(9) states that the period of limitations on the assessment of a gift tax (usually three years) will only start running if the gift is adequately disclosed on the gift tax return. The regulations list the information that is required and states that a qualified appraisal can satisfy the information requirements if it contains the necessary information and is performed by a qualified appraiser.

We will summarize the "Adequate Disclosure" regulations in our next issue. If you would like a copy of the final regulations please contact any one of our offices.

KTS CALENDAR

RECENT AND UPCOMING SEMINARS AND SPEAKING ENGAGEMENTS

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"
5/4/00	Presentation—Probus Group, Fullerton, CA.—"Valuation of Closely Held Businesses"
7/13/00	Presentation—Valuation 2000, Las Vegas, NV.—"The Deal"
8/29/00	Presentation—Internal Revenue Service, Chesterfield, MO.—"Gift and Estate Valuation Issues"
10/27/00	Presentation—Annual Probate Institute, Clayton, MO.—"Valuation Issues for Estates and Estate Planning"

KTS RECENT ENGAGEMENTS

* Fairness opinion for the Stock Bonus Retirement Plan of a privately held company being acquired by another privately held company.
* Valuation of the stock of a large construction company for ESOP purposes.
* Valuation of a developmental stage limited liability company to help settle a member dispute.
* Valuation of stock options of a developmental stage privately held company for a merger into a publicly traded company.
* Valuation of a privately held company for negotiation and possibly trial of a dissolution (marriage action).
* Valuation of development stage fiber optic components company for equity financing and joint venture arrangement.
* Valuation of several notes secured by first trust deeds or various types of real estate.

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 a free valuation seminar for your firm or professional group, please e-mail your request to info@ktsvaluation.com.

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Valuation Issues

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Quarterly Quote:

"You will never find time for anything. If you want time you must make it."

- Charles Buxton