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APPRAISAL PRACTICES BOARD

TO: All Interested Parties

FROM: Jay E. Fishman, Chair
Appraisal Practices Board

RE: Discussion Draft – *The Measurement and Application of Market Participant Acquisition Premiums*

DATE: April 16, 2013

The Appraisal Practices Board (APB) was officially formed by The Appraisal Foundation Board of Trustees on July 1, 2010. The APB has been charged with the responsibility of identifying and issuing voluntary guidance on recognized valuation methods and techniques, which may apply to all disciplines within the appraisal profession. As applied to valuation for financial reporting purposes this responsibility has been extended to best practices. The APB has prioritized topics to offer guidance in areas that appraisers and users of appraisal services have identified as the most pressing issues facing the profession.

Originally facilitated by The Appraisal Foundation, the work of the Valuation for Financial Reporting Work Groups is now formally adopted and published through the APB.

The Working Group on Control Premiums has developed this Discussion Draft on *The Measurement and Application of Market Participant Acquisition Premiums*. This document is a first draft containing questions and discussion points. Following receipt of comments on this Discussion Draft, an Exposure Draft will be provided for comment.

Request for Comments: The intent of this document is to obtain comments from all interested parties. Discussion questions are posed and the Working Group requests that responders send in both their reactions to these specific questions and to the document as a whole. Where appropriate, the Working Group would welcome specific numerical examples to illustrate the comment.

All interested parties are encouraged to comment in writing to the APB before the deadline of July 31, 2013. Respondents should be assured that each member of the Working Group will thoroughly read and consider all comments.

Written comments on this Discussion Draft can be submitted by mail, email and facsimile.

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If you have any questions regarding this Discussion Draft, please contact Staci Steward at (202) 624-3052 or staci@appraisalfoundation.org

IMPORTANT NOTE: All written comments will be posted for public viewing, exactly as submitted, on the website of The Appraisal Foundation. Names may be redacted upon request.

The Appraisal Foundation reserves the right not to post written comments that contain offensive or inappropriate statements.

The Appraisal Practices Board and The Appraisal Foundation wish to express our utmost gratitude to the *Working Group on The Measurement and Application of Market Participant Acquisition Premiums* for volunteering their time and expertise in contributing to this document. Specifically, sincere thanks to the following individuals:

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The views set forth in this exposure draft are the collective views of the members of this Working Group and do not necessarily reflect the views of any of the firms that the Working Group members are associated with.

The Appraisal Foundation served as a sponsor and facilitator of this Working Group. The Foundation is a non-profit educational organization dedicated to the advancement of professional valuation and was established in 1987 by the appraisal profession in the United States. The Appraisal Foundation is not an individual membership organization, but rather, an organization that is made up of other organizations. Today, over 110 non-profit organizations, corporations and government agencies are affiliated with The Appraisal Foundation. The Appraisal Foundation is authorized by the U.S. Congress as the source of appraisal standards and valuation specialist qualifications.

Discussion Draft:

The Measurement and Application of Market Participant Acquisition Premiums

Date Issued: To Be Determined

Application: Business Valuation, Intangible Assets

Background: Since the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 157 (FASB Statement No. 157), predecessor to Accounting Standards Codification ("ASC") 820 *Fair Value Measurement* (ASC 820) and Accounting Standards Update ("ASU") 2011-04;, and FASB Statement No. 141(R), predecessor to ASC 805 *Business Combinations*; and FASB Statement No. 142, predecessor to ASC 350 Intangibles, Goodwill and Other and ASU 2011-08, there has been increased interest in the identification and recognition of the fair value of assets and liabilities in financial statements. Furthermore, the FASB and the International Accounting Standards Board ("IASB") have been working on a convergence project with an objective of having a consistent set of accounting standards that can be used globally. In that regard, the IASB has issued International Financial Reporting Standards 3 (revised) *Business Combinations* (IFRS 3R) and IFRS 13 *Fair Value Measurement*, both of which are largely similar to the same statements issued by the FASB. Accordingly, during the creation of this document, members of the International Valuation Standards Council ("IVSC") have participated in certain discussions.

Because of the need for financial statements to be both reliable and relevant, valuation practices must provide reasonably consistent and supportable fair value conclusions. To this end, it is believed that guidance regarding best practices surrounding certain specific valuation topics would be helpful. The topics are selected based on those in which the greatest diversity of practice has been observed. To date, four Working Groups have been sponsored by The Appraisal Foundation. The first Working Group addressed the topic of contributory assets and charges in a document titled *The Identification of Contributory Assets and Calculation of Economic Rents* dated May 31, 2010 ("the CAC Document" now known as "Valuation Advisory #1"). A second Working Group has addressed the general topic of customer-related assets. This third Working Group is addressing the topic of the control premiums as applied in valuations done for financial reporting purposes. A fourth Working Group was recently formed to address the topic of valuing contingent consideration.

This document is intended to present helpful guidance for those that are preparing fair value measurements; however, this paper is not intended to be an authoritative valuation standard. The Working Group believes that consideration of the facts and circumstances related to the asset(s) that are being valued may support a departure from the recommendations of this document. It is the belief of the Working Group that the valuation of assets is a complicated exercise that requires significant judgment. This paper seeks to present views on how to approach and apply certain aspects of the valuation process appropriate for measuring the fair value of controlling interests.

TABLE OF CONTENTS

BACKGROUND

Premiums for control have long been a focus in business valuation.

Through the early 1990's, it was generally accepted that the publicly traded price of a company's shares represented the value of a minority interest and that, if the goal was to value a control interest a "premium for control" would be added to the value of equity indicated by that publicly traded price. That premium came generally came from market evidence in which the price paid to acquire an entire company was compared to the publicly traded price of that same company's shares prior to the acquisition.

However, in the late 1990's, this concept came into question and views have been changing. Various points have been made regarding why the control value of an entity might be no greater than that indicated by its publicly traded price.

There is no argument that the shares that transact in the public market are minority interests. However, that does not mean that the price paid for them represents "only" a minority value and that something more would be paid to gain control of that company. The fact that the company is still publicly traded might be evidence that no potential buyer believes there is value above the publicly traded price.

In any case, it has become relatively widely accepted that the market evidence supplied by dividing the acquisition price by the publicly traded price does not represent a premium for conceptual control but, rather, represents a premium paid linked to actual changes that can be made by exercising that control. Control, and whether one has it, is not really the focal point. What matters is that, after an acquisition, the acquired company is now under different management. A price higher than the publicly-traded price is reasonable if the new management and/or combined entity expect(s) improved cash flow or growth; or reduced risk. If no improvements or risk reduction could reasonably be expected, there is little reason for an acquirer to pay a price higher than the publicly-traded price. In such cases, the control value may approximate the publicly traded price.

INTRODUCTION AND SCOPE

This document (a "*Valuation Advisory*") sets forth best practices for certain issues encountered in measuring the fair value of controlling interests in business enterprises for financial reporting purposes. When valuing controlling interests in business enterprises, valuation specialists often reference the concept generally referred to as the control premium. The Appraisal Foundation's Task Force on Best Practices for Valuations in Financial Reporting has identified the use of control premiums in fair value measurement as an area of considerable diversity in appraisal practice.

The most common instances of such fair value measurements include Step 1 of the goodwill impairment test, portfolio valuation for investment companies, and application of the acquisition method of business combinations for step transactions. Of these, the Working Group believes Step 1 of the goodwill impairment test is most prevalent.

In a 2008 Securities Exchange Commission ("SEC") speech, the topic of control premiums was raised. It was stated that, in cases where control premiums appeared toward the high end of a reasonable range, the level of documentation required to support the control premium would also increase.[1]

In fulfilling its mandate to provide best practices in the context of measuring fair value for financial reporting purposes, the Working Group has elected to introduce the term market participant acquisition premium ("MPAP"). The purpose of introducing this new term is twofold: to emphasize the importance of the market participant perspective when measuring fair value, and to distinguish this premium from the more general (and occasionally controversial) notion of the control premium. The best practices presented in this Valuation Advisory have been developed for measuring fair value for financial reporting, and are not intended for other valuation contexts.

This Valuation Advisory is the result of deliberations by the Working Group and input received from interested parties.

[1] Robert G. Fox III, Goodwill Impairment on December 8, 2008, AICPA National Conference on Current SEC and PCAOB Developments

MARKET PARTICIPANT ACQUISITION PREMIUM

Concepts

Valuation specialists have long believed that the value of a business ownership interest is influenced by the degree of control available to the subject interest's owner. The International Glossary of Business Valuation Terms[2] defines control as "the power to direct the management and policies of a business enterprise." Both intuition and empirical observation suggest that the presence (or absence) of the so-called prerogatives of control may influence the value of a business ownership interest. In short, usually one would rather exercise control than not. As a result, investors might be willing to pay more for a controlling interest than for an otherwise comparable non-controlling interest in the same enterprise.

To induce a rational investor to pay more for a controlling interest, the prerogatives of control must give rise to incremental economic benefits. In other words, the prerogatives of control have little inherent value, but rather have value to the extent that their exercise enhances the economic benefits available to the owner of the subject controlling interest. Control may be valuable if the exercise of control will enhance the enterprise's cash flows and/or reduce the enterprise's risk. The International Glossary of Business Valuation Terms defines a control premium as "an amount or percentage by which the pro rata value of a controlling interest exceeds the pro rata value of a non-controlling interest in a business enterprise, to reflect the value of control."

Historically, the concept and/or measurement of the control premium has proven vexing and contentious to valuation specialists. Those of a more empirical disposition point to the range of premiums observed in closed transactions as a starting point for analysis, while others observe that the much larger population of public companies that are not acquired each year supports the theory that control premiums for most companies either do not exist or are quite small. In the context of fair value measurement, the Working Group desires to reorient discussion and analysis to the reasonable expectations of the relevant pool of market participants regarding cash flow enhancement and risk reduction at the measurement date.

Definition

The Working Group has introduced the MPAP, defined as the difference between (i) the *pro rata* fair value of the subject controlling interest and (ii*) its foundation.* The Working Group believes that valuation specialists most commonly associate the *foundation* with the *pro rata* fair value of marketable, non-controlling interests in the enterprise. Under these circumstances:

- For publicly traded companies, the foundation is equal to the quoted market price for the company's shares.

[2] The International Glossary of Business Valuation Terms contains valuation terms and definitions adopted by five North American professional organizations that recognize business valuation as a professional discipline; American Institute of Certified Public Accountants, American Society of Appraisers, National Association of Certified Valuation Analysts, The Canadian Institute of Chartered Business Valuators, and The Institute of Business Appraisers.

- For business enterprises that are not publicly traded, foundation is measured with respect to the current stewardship of the enterprise. In other words, the fair value of such interests contemplates that the prerogatives of control will continue to reside with the existing controlling shareholder or group of shareholders.

The above concepts are presented uniformly; in both cases the fair value per share on a marketable, non-controlling basis does not give consideration to discounts for lack of marketability. Also, while the preceding bullets describe an MPAP Equity Foundation concept, later in this document the Working Group introduces an alternative way to think about the MPAP. It proposes that instead of utilizing the Equity Foundation to determine an MPAP, usage of a Total Invested Capital ("TIC") Foundation may be more appropriate sometimes.

Control and Marketability

The MPAP definition does not ascribe a particular degree of marketability to the subject controlling interest. The issue of marketability for controlling interests is a source of diversity in practice, as some valuation specialists apply discounts for lack of marketability to derive the fair value of controlling interests in privately held companies, while others do not. The Working Group believes that it is inappropriate to apply discounts for lack of marketability when measuring the fair value of controlling interests. In most cases sellers would have access to a market as a forum to transact.

Among the prerogatives of control is the discretion to pursue an orderly sales process in order to realize the (undiscounted) value of the interest, while enjoying the benefits of ownership. The fair value of an interest contemplates the usual and customary marketing activities for such interests. Controlling interests should not be held to the same standard of marketability as publicly-traded equities because the markets differ. For controlling interests in business enterprises, the usual and customary marketing activities may be time-consuming. While the costs incurred to execute a transaction are real and not inconsequential, such costs are an example of the difference between the fair value of an interest and the net proceeds realized upon a sale.

Illustrative Examples

Two examples serve to clarify the MPAP definition. Consider first a business enterprise that is not publicly traded. The company's founder owns 70% of the outstanding shares and continues to exercise control over the enterprise. The remaining 30% of the outstanding shares are held by a number of investors, none of whom own more than 5%. Despite the availability of numerous investment opportunities with indicated positive net present values, the founder demonstrates little interest in growth and is averse to the use of debt financing. The price per share paid by market participants for a controlling interest is likely to exceed that paid for a non-controlling (albeit hypothetically marketable) interest. In other words, there is likely to be an MPAP. Its magnitude likely will be influenced by the perceived ability of market participants to exercise the prerogatives of control to increase the cash flows and/or reduce the discount rate applicable to the subject interest. Available strategies include making investments to spur revenue and earnings growth (thereby increasing cash flow), and employing a more typical financing mix for the industry (thereby reducing the weighted average cost of capital). Some market participants may also expect cost savings from eliminating redundancies.

Second, consider a business enterprise that is publicly traded. The business is generally believed to be well-managed, reporting operating margins in line with industry peers. The company has created and marketed a unique technology and has generated significant historical revenue growth. In this case, opportunities to generate economic benefits by exercising the prerogatives of control are more limited. However, market participants may own complementary technologies that, if marketed alongside that of the subject entity, would increase revenue growth. Alternatively, market participants may have existing distribution networks capable of handling the subject entity's products that would enhance profit margins. Similar to the other example, the market participant's perception of how prerogatives of control translate into value influences its investment decision.

In each case, the task of the valuation specialist is to identify and evaluate the feasibility of the available strategies from the perspective of market participants for the subject interest. The appropriate MPAP considers not only the magnitude of the available economic benefits, but also the degree to which such potential benefits will influence the price paid by a market participant for the subject controlling interest in an orderly transaction at the measurement date. The Working Group is not stating that the economic benefits must be precisely quantified in each case. Rather, at a minimum, analysis should be performed to identify which form(s) of economic benefit a market participant would reasonably expect to enjoy and some general magnitude of the effects of those benefits on value.

Concluding Observations

The Working Group believes that MPAPs should be supported by reference to either enhanced cash flows or a lower required return from a market participant perspective. The referenced economic benefits should be sufficient to provide market participants with an adequate return on the concluded fair value of the controlling interest. The Working Group anticipates such benefits will not in all instances be reliably identifiable, in such cases resulting in either no, or a small, premium.

Notwithstanding the emphasis on cash flow and risk differentials in supporting MPAPs in fair value measurement, the Working Group acknowledges the merit of analyzing historical data regarding observed premiums from closed transactions. However, to conform to best practices valuation specialists should critically evaluate the quality and relevance of such benchmark data to assess its applicability to the valuation subject. Relying solely on benchmark premium data to evaluate the reasonableness of the MPAP in a fair value measurement is not consistent with best practices.

CONCEPTUAL CONSIDERATIONS

The Working Group believes that a persuasive fair value measurement for a controlling interest in a business enterprise should be supported by a clear explanation of the incremental economic benefits available to market participants. In this section of the Valuation Advisory, we discuss the prerogatives of control that are the means for generating economic benefits and provide examples of the economic benefits typically associated with exercising control over a business enterprise. We also discuss the characteristics of a business enterprise that are likely to influence the magnitude of the economic benefits available to market participant acquirers of a controlling interest.

Prerogatives of Control

The prerogatives of control refer the rights possessed by the owner of a controlling interest in a business enterprise to direct the management and policies of a business enterprise. Following is a non-exhaustive list of the specific means by which such control is exercised[3]:

1. Appointing or changing operational management
2. Electing members of the board of directors
3. Determining management compensation and perquisites
4. Setting operational and strategic policy for the business
5. Acquiring, leasing, or liquidating business assets
6. Selecting suppliers, vendors, and subcontractors
7. Negotiating and consummating mergers and acquisitions
8. Liquidating, dissolving, selling, or recapitalizing the company
9. Selling or acquiring treasury shares
10. Registering the company's equity securities for an initial or secondary public offering
11. Registering the company's debt securities for public offering
12. Declaring and paying dividends
13. Changing the articles of incorporation or bylaws
14. Selecting joint venture and other business partners
15. Making product and service offering decisions
16. Making marketing and pricing decisions
17. Entering into licensing and other agreements regarding intellectual property
18. Blocking any or all of the above actions

The Working Group believes that the prerogatives of control noted above have no inherent value, but are rather the means through which market participants implement strategies designed to generate economic benefits. For example, the bare ability to select a company's suppliers conveys no particular economic benefit to a market participant, and therefore does not influence the fair value of a controlling interest. However, if selecting suppliers with whom a market participant has existing relationships allows the market participant to achieve a lower cost of sales, that economic benefit will potentially influence the MPAP.

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[3] Most, if not all, of these items are based on a list appearing in Business Valuation Discounts and Premiums; by Shannon P. Pratt, CFA, FASA, MCBA, John Wiley & Sons, Inc., Second Edition, 2009.

Economic Benefits of Control

The Working Group believes that the economic benefits of control that support MPAPs are ultimately manifest in two ways: enhanced cash flows or lower required returns. The task of the valuation specialist is to identify the economic benefits available to a market participant and support a magnitude of the amount by which such benefits may reasonably be expected to increase the price paid by a market participant for the subject interest over its Foundation value.

Enhanced Cash Flows

Market participants contemplating purchase of a controlling interest in a business enterprise often anticipate implementing business strategies that are not available to non-controlling investors under current stewardship. These strategies may increase cash flows or improve investment returns through other strategy revisions. As stated previously, we will refer to the concept of cash flow improvement to connote all forms of value-enhancing investment and operational strategies. In all cases, an acquisition premium would only be supported by changes believed to enhance the total return on investment. Potential improvements may include the following areas, which are illustrative and not intended to be an all-inclusive list:

- *Superior revenue growth.* Market participant acquirers may have greater financial capacity and/or willingness to invest more in positive net present value projects to fuel future revenue growth than the incumbent ownership group. Alternatively, market participants may have complementary products or services that are expected to increase sales of the subject entity, the market participant acquirer, or both. Market participants may have existing relationships with customers that have previously been inaccessible to the subject entity. In addition, market participants may have existing distribution networks that are broader than those of the subject entity that could contribute to superior revenue growth.

- *Increased operating margins.* Market participants may anticipate increasing the subject entity's operating margins through eliminating redundant operating costs or achieving economies of scale through the addition of incremental sales volume. Larger companies are often able to negotiate superior terms with suppliers, resulting in lower cost of sales.

- *Working capital efficiencies.* Relative to the subject entity under current stewardship, market participants may expect to maintain lower cash balances, negotiate more favorable payment terms or inventory delivery schedules with suppliers, or have tighter credit policies.

- *Capital expenditure efficiencies.* Market participants may have more favorable ongoing access to necessary capital equipment, or they may be able to consolidate production and distribution capacity of the subject entity.

Regardless of the source, to be relevant in differentiating the fair value of a controlling interest, the enhanced cash flows must be incremental to those expected by the subject entity under current stewardship. In other words, enhanced cash flows giving rise to an MPAP are incremental to prospective financial information that reflects the ongoing operations of the business enterprise absent a change of control transaction.

Lower Cost of Capital

When evaluating the purchase of a controlling interest in a business enterprise, market participants may have a lower required return than investors contemplating the purchase of an otherwise comparable non-controlling interest. The Working Group believes there are four reasons a market participant may have a lower required return for a controlling interest.

- *Optimized capital structure.* If the subject entity employs a suboptimal mix of debt and equity financing, the weighted average cost of capital may be reduced by adjusting the subject entity's capital structure. While it may be more common for companies to use a less-than-optimal amount of debt financing, the costs of financial distress may also cause an over-leveraged company to have an unfavorable cost of capital.

- *Company size and diversification benefits.* Most valuation specialists agree that, all else equal, larger companies enjoy lower costs of capital than smaller companies. Often, market participants are larger than the subject entity and therefore have a lower cost of capital. Alternatively, if the operations of the subject entity have negative correlation to the existing operations of the market participants, acquisition of the subject entity may reduce the market participant acquirer's cost of capital because of the resulting diversification of operations.

- *Reduced operating risk.* Market participants may perceive opportunities to reduce the operating risk of the business through strategies designed to reduce the volatility of raw material pricing, adopting a more variable cost structure, or securing more long-term customer contracts. Such measures may reduce the operating risk, and cost of capital, for the business enterprise.

- *Investment strategy improvements*. Market participants may be able to improve the overall return on investment of the enterprise though reorientation of investment. This may include acquisition, divestiture, discontinuation or other forms of investment policy change.

Such effects will influence the magnitude of the MPAP only to the extent market participants are willing to credit the subject entity with the economic benefits resulting from a lower cost of capital.

Discussion question regarding lines 242 – 270:

There appear to be differing opinions regarding market participants' view of the size of the target and how it influences the cost of capital. Some believe that market participants may use a cost of capital commensurate with the actual size of the target as it stands. Others believe that market participants use a cost of capital reflecting the benefits of the increased size and diversification of the combined entities post-transaction. Please provide commentary on this topic.

Summary

The Working Group cautions that it may not be appropriate to assume that market participants will always incorporate all economic benefits of control into the price paid for a controlling interest in a subject business even if such benefits exist. The Working Group believes market participants are not willing to pay a price with no prospects of an economic return. In other words, theoretically market participants do not give away all of their upside - the incremental economic benefits - that may arise from a transaction.

Furthermore, the Working Group believes that it is incorrect to assume that the market has “underpriced” non-controlling interests in the subject entity in measuring the magnitude of an MPAP for a controlling interest. For example, stock analysts frequently publish price targets for the shares of publicly traded companies. The existence of price targets in excess of the prevailing stock price does not provide direct evidence of the MPAP. In such cases, the valuation specialist should investigate the investment thesis underlying the price target. If the price target is premised on the expectation that the company may soon be “in play” for a change of control transaction or an expectation that a controlling interest buyer would implement strategies to increase the economic benefits generated by the firm, such price targets may provide indirect support for an MPAP. If, on the other hand, the price target reflects an expected future change in market sentiment for non-controlling interests in the subject entity, the price target will provide only limited or no support for an MPAP.

BUSINESS CHARACTERISTICS INFLUENCING MARKET PARTICIPANT ACQUISITION PREMIUM

As valuation specialists evaluate the potential economic benefits that may be derived from exercising the prerogatives of control, it is important to assess the reasonableness of the assumed economic benefits in the context of the characteristics of the subject business enterprise and the industry in which it operates. The following discussion is not intended to be comprehensive, but is representative of the factors that valuation specialists should consider in estimating the price market participants would pay for the subject controlling interest.

Acquisition Activity in the Industry

The number of change of control transactions in a given industry fluctuates over time. When the frequency of transactions in an industry increases, it may signal that market participants perceive greater opportunities to generate economic benefits by exercising the prerogatives of control. For example, regulatory or other changes may favor a smaller number of larger industry players, prompting a round of consolidation. Alternatively, acquisition activity may increase because economic turmoil is causing the financially weaker members of the industry to seek to be acquired by more stable and less financially distressed companies.

Robust acquisition activity in the industry may increase the number of market participants that would contemplate acquiring a controlling interest in the subject entity. As a result, the selling shareholders may be able to realize a greater portion of the economic benefits available to market participant acquirers, thereby increasing the fair value of the controlling interest and, by extension, the MPAP.

As a consolidation trend for an industry is confirmed by an increasing number of announced transactions, the fair value of non-controlling interests in the subject entity may increase as investors come to expect that a change of control transaction on favorable terms is imminent. In such cases, the MPAP may be reduced as the difference between the fair value of controlling and non-controlling interests is compressed.

Stage in Company Life Cycle

Growth-stage target companies generally offer greater opportunities for realizing economic benefits than more mature companies. For example, market participants may be able to leverage existing distribution networks that growth-stage companies have not yet had the opportunity or financial resources to develop, providing opportunities for superior revenue growth and/or enhanced operating margins. Mature target companies, on the other hand, are likely to present fewer opportunities for enhanced cash flows or lower cost of capital. As a result, the appropriate MPAP may be lower for such companies.

Market Participant Attributes

Market participants are commonly classified into three general categories.

- *Strategic acquirers* already operate in the same business as the subject entity. Revenue synergies and cost savings tend to be the most important economic benefits available to strategic acquirers exercising the prerogatives of control. Strategic acquirers may be competitors of, suppliers to, or customers of the subject entity.

- *Financial acquirers* do not have any existing complementary business operations. Financial acquirers such as private equity and venture capital funds are less likely to identify significant revenue synergies or operating cost savings than strategic acquirers. Financial acquirers may possess financing advantages relative to strategic acquirers.

- *Conglomerate acquirers* are operating companies that acquire the subject entity to increase the diversification of the acquirer's existing revenues and cash flows. While there may be some administrative efficiencies that are expected to contribute to enhanced cash flows, the expectation of diversification benefits, and thus lower risk, causes the benefits available to conglomerate acquirers to more closely resemble financial rather than strategic acquirers.

While this classification is helpful for evaluating the attributes of market participants and the nature and magnitude of economic benefits those market participants will expect from exercising control over the subject entity, the Working Group emphasizes that the boundaries between the categories are permeable. For example, financial acquirers often acquire controlling interests in companies to "bolt on" to existing portfolio investments, thereby resembling strategic acquirers in many respects. In addition, financial acquirers may anticipate significant cash flow enhancements from replacing what they perceive to be an inept management team, or from eventual sale to a strategic acquirer or through favorable initial public offering pricing. Likewise, strategic or conglomerate acquirers may have access to financing arrangements on terms at least as favorable as financial acquirers.

Valuation specialists should identify market participant attributes and correlate the expected economic benefits of control to the likely strategies of such acquirers. In many cases, strategic, financial, and conglomerate acquirers compete with one another for the same targets, and the fair value of controlling interests could appear to encompass a mix of strategic and financial benefits.

Size of Market Participants Relative to Subject Entity

Market participant acquirers are often larger than the subject entity. This is unsurprising, as larger companies may be positioned to realize economic benefits from exercising control that are not available to a smaller company on a stand-alone basis. For example other factors being equal, larger companies are more likely to have favorable access to capital, existing distribution infrastructure and administrative capacity, and superior negotiating leverage with suppliers and customers. As a result, the larger market participant may be able to extract greater economic benefit from exercising control over the subject entity – and in a shorter period of time. As a result, the MPAP may be positively related to the size of the market participants for the subject controlling interest.

Balance of Information

Market participants forecast the economic benefits to be realized from exercise of control on the basis of information discovered during due diligence procedures. Assuming the subject entity is a willing party to the selling process, the due diligence associated with acquisition of a controlling interest is likely to yield information not available to investors in non-controlling interests in the subject entity. The Working Group has identified three varieties of information asymmetry that can influence the magnitude of the MPAP.

1. *Information available to market participants for controlling interests, but not market participants for non-controlling interests.* In general, the subject entity's Equity Foundation reflects only publicly available information regarding the subject entity. However, at the measurement date there may be relevant information regarding the results of operations or other factors that is disclosed to market participants for controlling interests but not yet publicly disseminated. For example, if the measurement date coincides with the end of the subject entity's reporting period, operating results for the period are likely known by the company with a considerable degree of certainty although the company may have issued only limited guidance to analysts and investors so that the publicly traded share price does not reflect the information. The existence of non-public information favorable to the subject entity may support a larger MPAP; if the non-public information is unfavorable, that may indicate a lower MPAP.

2. *Information known to the subject entity but not market participants.* If the information is favorable to the subject entity, it is likely to be disclosed to the market participants during due diligence. Under the definition of fair value, market participants are assumed to be "knowledgeable, have a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary."[4] As a result, even if the subject entity would prefer that market participants not be aware of unfavorable information, such information is assumed to be known in measuring fair value resulting in a comparatively lower MPAP. The Working Group believes the *good news* scenario revealed to the market participant would increase the MPAP.

[4] ASC 820-10-20.

3. *Information known only to a single market participant, but not the subject entity.* A particular market participant may be able to take advantage of unique revenue synergies or cost savings. If this information is truly specific to a single market participant, the effect on the fair value of the subject controlling interest is likely to be modest as the market participant would be unwilling to pay more than the value of the economic benefits available to the next most advantageously positioned market participant.

The Working Group cautions that the existence and magnitude of most information asymmetries is difficult to support. Further, the degree to which the balance of information contributed to historical observed transaction premiums will, in most cases, be impossible to discern.

Discussion question regarding lines 377 - 414:

Is this an appropriate treatment of this topic? Please elaborate.

Capital Structure of Subject Entity

Among the prerogatives of control is the ability to adjust the subject entity's capital structure. As discussed previously, shifting to a more optimal capital structure is one strategy for reducing the weighted average cost of capital. The farther the subject entity's capital structure is from the optimal financing mix, the greater the potential MPAP.

Management Objectives

Privately held companies often are managed with objectives that differ from what those objectives might be if the company was publicly traded. This is not necessarily a matter of "quality" of management (addressed in the next section), but might be a matter of these parties having different goals. Such differences might include above-market compensation paid to the private company owner, lease rates that do not reflect market conditions, avoidance of the use of debt financing, and cash at levels above industry norms and other similar factors.

Depending on how these factors are addressed in determining the Foundation value, the MPAP for such a privately held company might exceed that measured for many publicly traded entities.

Quality of Management

Another prerogative of control is the ability to change the subject entity's management team. If the quality of the incumbent management team is perceived by market participants to be low, it may increase the likelihood that strategies to enhance cash flows or reduce the cost of capital can be successfully implemented, which will contribute to a larger MPAP. Conversely, if the quality of the management team is acknowledged to be high, opportunities to realize economic benefits are likely to be limited, resulting in a smaller MPAP.

While the notion of management quality is inherently subjective, there are objective metrics that can provide insight regarding the effect of current management policies. Benchmarking growth, profitability, asset utilization, and cost of capital to peer companies can serve as a proxy for the quality of incumbent management. However, such measures must be interpreted in the context of the management team's tenure and firm-specific factors, such as contracts, facilities, and other assets that were inherited from prior management teams.

The Working Group observes that poor quality management is unlikely to be a factor cited in support of an MPAP since it rarely will be acknowledged by the management team responsible for the fair value measurement. Nonetheless, it is an important consideration and highlights the importance of comparative financial analysis when evaluating the economic benefits that may be available to market participants exercising control over a business enterprise.

Finally, it should be noted that, no matter how well current management might perform, the holder of a non-controlling interest is at a comparative disadvantage because management might change or the direction of current management might change in a way incongruent with the non non-controlling interest owner's preferences. A non-controlling interest cannot prevent these occurrences.

Regulatory Factors

Regulatory factors can be significant considerations in business combinations. In addition, regulatory factors can mitigate or amplify the degree of control exercised by a particular ownership interest. Purchase prices and acquisition premiums in transactions outside the U.S. can differ significantly from those inside the U.S. because of different regulatory environments.

There are a variety of regulatory factors that may be relevant to the analysis of the MPAP:

- *Regulations governing merger and acquisition activity.* Some regulations, such as anti-trust provisions designed to limit the potential for monopoly power, may directly affect which market participants are potential acquirers of the subject entity. Regulatory provisions that significantly reduce the number of potential bidders for the subject entity may have a dampening effect on the MPAP.

- *Limitations on foreign direct investment.* As with anti-trust provisions, those aimed at limiting the ability of foreign market participants to acquire a controlling interest in the subject entity may reduce the MPAP applicable to the subject entity.

- *Investor protection measures.* Investor protection measures such as uniform accounting standards and corporate securities laws are generally designed to protect non-controlling investors. Some measures may even grant non-controlling shareholders in a business enterprise the right to block the controlling owner's ability unilaterally to exercise certain of the prerogatives of control. Since the MPAP measures the difference between the fair value of controlling and non-controlling interests, regulations that increase the fair value of non-controlling interests will, all else equal, reduce the MPAP.

- *Industry-specific regulations.* Some industries, like banking and telecommunications, are governed by a host of industry-specific regulations that govern the conduct of, and competition among, firms within the industry. Such industry regulations can shift with economic conditions and the political environment. Industry-specific regulations that are perceived to promote consolidation activity may increase the MPAP. If instead the prevailing regulatory stance is one of limiting acquisition activity, the appropriate MPAP may be lower.

The influence of regulatory factors should be evaluated relative to observed transaction activity in the subject entity's industry.

Corporate By-Laws and Governing Documents

Valuation specialists should consult the subject entity's corporate by-laws and other governing documents to determine whether there are any provisions that may restrict the ability of the subject controlling interest to exercise control over the business enterprise.

The Working Group believes it is a mistake to conceive of control as absolute; rather, control of the enterprise should be evaluated along a continuum extending from substantial minority investments to complete ownership of all equity share classes. For example, the subject entity's governing documents may grant preferred shareholders the right to vote as a class on certain corporate actions or to elect a certain number of corporate directors. In other cases, a supermajority vote of the common shares may be required to approve a sale of the business.

Some companies issue both voting and non-voting shares with the economic rights of the non-voting shares being identical to the voting shares. Observed differences between trading prices for non-controlling interests in the two share classes are typically very small. Because this is based on a comparison of the prices of non-controlling interests, such data is of little use in the analysis of MPAP.

Transaction Structure

The structure of a transaction can exert a significant influence on the nominal price paid for a controlling interest. The tax characteristics of a transaction, including the availability of amortization benefits to the market participant acquirer, can affect the purchase price. The Working Group observes that accounting standards for goodwill impairment testing require the valuation specialist to identify whether the fair value measurement assumes a taxable or non-taxable transaction structure.

Controlling interest acquisitions often include contingent consideration arrangements. Depending on how the contingent consideration is measured, the nominal purchase price may be overstated or understated. Recent changes to the accounting for business combinations that include contingent consideration have – at least temporarily – increased the difficulty of interpreting market data from closed transactions.[5]

[5] The Working Group notes that contingent consideration arrangements are less common in acquisitions of public companies (the basis for observed transaction premiums).

Valuation specialists should carefully consider the influence of transaction structure on both observed transaction multiples and control premiums, as well as fair value measurement of the subject controlling interest. Unfortunately, important details that would permit careful analysis of closed transactions are usually unavailable.

Summary

In summary the Working Group believes this section illustrates many of the factors that valuation specialists would consider in estimating the price market participants would pay for the subject controlling interest. The preceding listing and discussion of business characteristics and considerations is not intended to capture all things that deserve consideration when assessing factors that may influence an MPAP. Instead the Working Group focused on topics that - based on its collective professional experiences - are encountered most often in practice. Consideration of these concepts may be helpful when performing original analysis to develop an MPAP. Also, these concepts can be useful in assessing the reasonableness of another party's MPAP analysis, for example in a peer or specialist review context.

Conclusions

A well-supported fair value measurement for a controlling interest in a business enterprise should include consideration, from the market participant perspective, of the incremental economic benefits of control. The prerogatives of control may lead to economic benefits in many areas and the valuation specialist should review the typical business characteristics likely to influence the magnitude of the benefits available to market participant acquirers of a controlling interest.

The Working Group believes that use of the framework discussed will provide an important context for review of the valuation results, and will increase the relevance and reliability of the associated fair value measurement.

ANALYTICAL METHODS

The remaining sections of this Valuation Advisory address some of the important analytical methods involved in expressing MPAPs, analyzing observed premiums from historical transactions, and assessing the reasonableness of the concluded MPAP.

Expressing the Market Participant Acquisition Premium

Although the MPAP may be expressed as a dollar amount (the difference between the *pro rata* fair value of a controlling interest and its Foundation), valuation specialists customarily express valuation premiums and discounts as the percentage difference. This is intuitive and facilitates the comparison of premiums across companies of different sizes.

Valuation specialists have traditionally used the Equity Foundation to calculate the transaction premium as a percentage. This is consistent with the methodology for reporting premiums used by *Mergerstat Review* which based on its experiences, the Working Group observes to be the most widely-cited source of historical control premium data. It is also consistent with how premiums are commonly reported in the financial press.

In deliberating the MPAP, the Working Group concluded that the traditional method of calculating transaction premiums is potentially misleading. The economic benefits realized through exercising the prerogatives of control enhance the fair value of the enterprise as a whole, not just the fair value of the equity. Further, expressing the MPAP as a percentage of the Foundation on an equity basis distorts the comparability of the MPAP among companies with different capital structures. For example, assume Foundation TIC value for both Company A and Company B is $100 million. Company A has $10 million of interest-bearing debt outstanding, and Company B has interest-bearing debt of $50 million. Assume further that, from the perspective of a market participant, the magnitude of economic benefits from exercising the prerogatives of control for Company A is identical to that for Company B, such that the MPAP applicable to each company is $20 million.

As shown in the following table, the traditional method of expressing the premium as a percentage of the Equity Foundation will cause the MPAP for Company A to appear smaller than that of Company B. However, when expressed as a percentage of the TIC Foundation, the MPAPs – which are economically equivalent (the same dollar amount) – are identical.

	Company A	Company B
Fair Value of Interest-Bearing Debt	$10.0	$50.0
Fair Value of Equity	90.0	50.0
Fair Value of Total Invested Capital	$100.0	$100.0
(Marketable, Non-controlling Interest Basis)		
Fair Value of Total Invested Capital	$120.0	$120.0
(Controlling Interest Basis)		
Market Participant Acquisition Premium	$20.0	$20.0
Traditional Method		
Market Participant Acquisition Premium	$20.0	$20.0
Fair Value of Equity	90.0	50.0
(Marketable, Non-controlling Interest Basis)		
Market Participant Acquisition Premium (%)	22.2%	40.0%
Total Invested Capital Method		
Market Participant Acquisition Premium	$20.0	$20.0
Fair Value of Total Invested Capital	100.0	100.0
(Marketable, Non-controlling Interest Basis)		
Market Participant Acquisition Premium (%)	20.0%	20.0%

The Working Group believes that best practices include expressing as well as applying the MPAP in the context of a TIC Foundation. The Working Group acknowledges that following this best practice will require the restatement of observed transaction premiums that have been traditionally expressed based on an Equity Foundation. Nonetheless, the Working Group believes that the benefits of doing so (alignment with the underlying economic benefits giving rise to the MPAP, and greater comparability across firms with different capital structures) outweigh the incremental effort. The Working Group notes that since the observed transaction premiums relate to publicly-traded companies, the information is ordinarily available to enable expression of the observed transaction premiums using a TIC Foundation

Analyzing Historical Premium and Transaction Data

Transactions in which the buyer acquires a controlling interest in a publicly traded company afford opportunities to observe the magnitude of premiums paid by acquirers. Valuation specialists often reference observed premiums when estimating or supporting the MPAP for the subject entity. Although similar premiums presumably also exist in the acquisition of private companies, the absence of an observable Foundation price for the acquired company precludes calculating reliable premiums. However, such transactions may yield reliable multiples of revenue, earnings measures, or other relevant metrics that are indicative of the fair value of a controlling interest.

The Working Group cautions that exclusive reliance on observed premium data provides, in most cases, insufficient support for a concluded MPAP. Nonetheless, observed transaction premium data may be valuable. The Working Group believes that observed historical premiums provide potentially relevant (albeit indirect) evidence of the appropriate magnitude of the incremental economic benefits from exercising control anticipated by market participants. The observed premiums can be used to corroborate (or question) the reasonableness of the cash flow forecasts and discount rates underlying fair value measurements within the income approach. However, exclusive reliance on observed transaction premiums without careful analysis of the subject entity's relative financial performance, valuation multiples and other metrics can result in an unreliable fair value measurement.

The Working Group believes that the valuation specialist may consider the qualitative factors discussed in the earlier section – *Business Characteristics Influencing Market Participant Acquisition Premium* – to narrow the range of observed premiums from the transaction data that may be applicable for the subject entity.

Assessing the Underlying Data Set – Transaction Data

Valuation specialists should carefully analyze available transaction data, considering various factors specific to the acquired company, the seller, the acquirer, or the transaction that may warrant adjustments to the data. Factors valuation specialists should consider include the following:

- *Size of Interest Transacted.* The valuation specialists should attempt to ascertain whether the interest transacted represents 100% ownership of the company. As discussed previously, there is a continuum of control, and ownership interests of less than 100% may not be able unilaterally to exercise the prerogatives of control.

- *Financial Condition of Seller.* Transactions involving sellers motivated by financial distress or bankruptcy usually do not provide reliable evidence for fair value measurement.

- *Relationship of Buyer and Seller.* If the parties to the transaction have some pre-existing relationship, it may indicate that the transaction terms do not reflect arms'-length negotiation, which would limit the usefulness of the transaction data when measuring fair value.

- *Transaction Structure.* Especially for transactions involving private companies, an array of transaction structure concerns can distort the reported data. For example, acquirers may purchase either the stock or the assets of the target company. Certain corporate assets such as cash or real estate may not be included in the transaction. The consideration may include a note bearing interest at other than a market rate. Contingent consideration arrangements are often difficult to convert to cash-equivalent value at the transaction date (and may be excluded altogether from a reported price). Occasionally employment or lease agreements with the seller may be executed simultaneously that are properly considered components of the economic purchase consideration.

- *Transaction Process.* The valuation analyst should endeavor to ascertain whether the transaction was the culmination of a deliberate selling and marketing effort administered by competent investment bankers, a hostile takeover, or negotiation with a single acquirer.

- *Transaction Status.* Referenced transactions may have been announced, but not yet closed at the measurement date. In such cases, valuation specialists should carefully consider how much weight to give to such transactions.

Given the limited availability of data regarding most change of control transactions, it is unlikely that valuation specialists will be able to obtain a comprehensive understanding of the factors described above for each transaction relied on. Nonetheless, by considering these factors, valuation specialists may be able to exclude transaction data that is misleading for the subject fair value measurement.

Discussion question regarding lines 573 - 630:

Please comment on any other areas of analysis practiced or observed that would be important to understand or explore as it relates to Historical Premium and Transaction Data in a fair value measurement.

Other Considerations – Historical Premium Data

Available data regarding observed premiums in historical transactions present additional challenges for valuation specialists.

In many cases, there will be a trade-off between the quantity of available premium data and the quality of the data (in other words, the data's relevance to the fair value measurement). Valuation specialists should evaluate the relevance of referenced premium data by considering the degree to which the target company is comparable to the subject entity, and whether the acquirer is representative of market participants for the subject entity at the measurement date.

The number of referenced transactions can be increased by considering those occurring during a longer window preceding the measurement date. However, transactions more proximate to the measurement date are generally preferable, especially when consolidation trends within the subject entity's industry have evolved. When evidence from transactions near the measurement date is limited or not available, valuation specialists may wish to consider industry premiums over a longer period, such as one, three, or five years prior to the measurement date. However, when doing so, valuation specialists should be careful to consider what effect, if any, changes in economic, market, or industry factors may have had on the level of observed premiums over the period analyzed.

The reported magnitude of the observed premium from a transaction is affected by the date selected to serve as the basis for expressing the premium (the date of the Foundation price). Valuation specialists should review the target company's public share trading volume and price fluctuations for the weeks leading up to the transaction announcement date to identify any unusual or unexplained market activity. For example, if the target company had retained a financial advisor to explore strategic alternatives, or negotiations with potential acquirers are known to the public, it is preferable to calculate the transaction premium using a price from a date before such information began to be incorporated into the target company's publicly-traded stock price.

Valuation specialists routinely consider premiums calculated from one to thirty days prior to the transaction announcement date. Valuation specialists may also calculate transaction premiums based on the average stock price over a period. The Working Group believes that, if applied consistently, such techniques can be used to improve the relevance and reliability of historical premium data.

Limitations Inherent in Observed Premium and Transaction Data

As noted in the previous sections of this Valuation Advisory, valuation specialists relying on observed premium and transaction data must be vigilant to ensure that the data has been evaluated for comparability and relevance to the subject entity.

Beyond these issues, valuation specialists should be aware of more fundamental concerns that may limit the usefulness of such data when measuring the fair value of a controlling interest.

- *Selection bias.* Acquisition premiums and other transaction data may be subject to selection bias since the population of observed transactions is limited to those companies that have been acquired. Some valuation specialists emphasize that such companies typically represent only a small portion of the universe of companies available to be acquired. While not subject to empirical verification, one potential conclusion from this observation is that the control value of the much larger population of companies not acquired is not greater than the companies' market capitalization because control would offer no incremental economic benefits to induce an acquirer to seek control.

In any case, since the premiums and transaction multiples applicable to the companies not acquired cannot be observed, application of observed premiums or implied transaction multiples to the subject entity may introduce an upward bias in the resulting fair value measurement. Stated alternatively, transaction data may be drawn from a sample limited to those companies for which the premiums would be highest; the valuation specialist must carefully assess whether the subject entity is comparable to acquired companies in the sample. The Working Group believes that the valuation specialist may consider the qualitative factors discussed in the earlier section – *Business Characteristics Influencing Market Participant Acquisition Premium* – to narrow the range of observed premiums from the transaction data that may be appropriate for the subject entity.

- *Acquirer-specific synergies.* Setting aside the potential for selection bias, data from closed transactions may reflect acquirer-specific synergies not available to the relevant pool of market participants. Specific synergies not available to market participants are excluded from the definition of fair value. In most cases, the specific considerations motivating the parties to the transaction cannot reliably be discerned from the available transaction data. As a result, it is difficult for valuation specialists to precisely determine the degree to which the observed premiums and transaction multiples are relevant when measuring the fair value of the subject controlling interest.

- *Negative observed transaction premiums.* Referenced sources of transaction premium data often include negative premiums. Negative transaction premiums are observed when the price per share paid for a controlling interest is less than the contemporaneous Foundation price. The Working Group believes that negative observed transaction premiums should be disregarded when measuring fair value. The Working Group believes that, absent anomalous circumstances with respect to either the market for the subject entity's shares or the transaction process for the controlling interest (neither of which would be relevant in measuring fair value), market participants would be unwilling to sell to a controlling interest acquirer at a price less than the Foundation price.

Each of these concerns underscores the importance of careful analysis of the incremental economic benefits available to market participants through exercising the prerogatives of control. The Working Group affirms the value of identifying and referencing observed historical premiums and other transaction data; however, exclusive reliance on such data is not consistent with best practices for fair value measurement.

Assessing the Reasonableness of the Concluded Market Participant Acquisition Premium

A credible fair value measurement should include an assessment of the overall reasonableness of the measurement, including the MPAP applied or implied by the analysis. While premiums are conventionally expressed as a percentage of the Equity, or in some cases the TIC Foundation, the Working Group believes that the overall reasonableness of the fair value measurement should be assessed more broadly.

Defined as the difference between two measures of fair value (the controlling interest and Foundation), the MPAP is – strictly speaking – a byproduct of the valuation process rather than an exogenous input. While valuation specialists commonly estimate the MPAP as an input in measuring the fair value of a controlling interest, the level of rigor of analysis would depend on the importance of the MPAP to the fair value measurement. Valuation specialists may consider using the following techniques to evaluate the reasonableness of the fair value measurement of a controlling interest in a business enterprise:

- *Relative value measures.* When feasible, valuation specialists should calculate ratios of invested capital to relevant performance measures, such as revenue, EBITDA, or other industry-relevant metrics. When an MPAP has been added to a Foundation value, comparison of the resulting relative value measures to transaction multiples observed from the available transaction data might assist the valuation specialist in confirming the reasonableness of the selected premium.

- *Prospective Return Analysis*. The MPAP is a function of the incremental economic benefits anticipated by market participants from exercising the prerogatives of control. If the guideline public company approach is the primary method used in measuring fair value, the valuation specialist might consider calculating the discount rate implied by the effective earnings multiple. Comparing the implied discount rate to the weighted average cost of capital for market participants can help confirm the reasonableness of the MPAP.

- *Reconciliation to prior transactions in the subject entity.* In some instances, transactions for debt or equity interests in the subject entity will have occurred during a relevant period of time leading up to the measurement date. Market transactions may include those involving the subject controlling interest, a non-controlling interest in the subject entity, or other debt or equity securities of the subject entity. The valuation specialist should carefully assess whether the market transactions were arms'-length and orderly, and if so, reconcile the fair value measurement to the terms of the market transaction, taking into account changes in the market since the transaction and fundamental differences between the subject controlling interest and the interest transacted.

- *Reconciliation to prior fair value measurements.* If fair value measurements have been prepared for the subject controlling interest in prior periods, valuation specialists should understand the change in fair value, noting especially the valuation inputs that contributed most directly to the change. If the valuation specialist has relied on different valuation methods than in prior fair value measurements, the change should be noted and explained, preferably with respect to fundamental changes in the business or availability of information that have resulted in a more reliable fair value measurement.

- *Comparison to public market capitalization.* When measuring the fair value of reporting units of public companies, the Working Group believes that the concluded aggregate fair value of the reporting units (on a controlling interest basis) should be compared to the market capitalization of the company on the measurement date. The MPAP for the entire company implied by such a comparison might be a barometer of the overall reasonableness of the fair value measurement. However, there are cases in which there would reasonably be a difference between the aggregate control value of the reporting units and the control value of the total company, such as a conglomerate for which the parts might be worth more than the whole or a company whose shares are very thinly traded.

Valuation specialists may consider myriad value indications when several valuation methodologies are available and relevant for consideration in appraising a single valuation subject. ASC 350-20-35-22 states that "the market price of an individual equity security (and thus the market capitalization of a reporting unit with publicly traded equity securities) may not be representative of the fair value of the reporting unit as a whole." ASC 350-20-35-23 further states that "measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities…The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit."

However, when reporting units are appraised under ASC 350, whether for entities with one or several reporting units, the entity's market capitalization has been commonly referenced as indirect value evidence even in cases where the unit of account prescribed by ASC 350 (i.e., the reporting unit) may be different from the quoted unit of measurement (i.e., the individual shares of the entity). In the case of multiple reporting units, additional adjustments have been made to present the best apples-to-apples comparison. In other words the strength of quoted evidence was compelling enough to consider even with an understanding that the quoted price was not necessarily directly linked to the valuation subject.

During the economic crisis circa 2008 the market for, and fair value of, many assets and companies declined and the level of difficulty in measuring value increased. At the 2008 AICPA National Conference on SEC and Public Company Accounting Oversight Board ("PCAOB") Developments, the SEC offered its view of how market capitalization may be used when assessing goodwill impairment. In particular, the SEC staff indicated that they would expect objective evidence to support the reasonableness of implied control premiums, whether a quantitative or qualitative analysis (or both) was used. The SEC staff also indicated that while judgment may result in a range of reasonably possible control premiums, they expect the rigor of documentation to increase as the control premium increases.

Whereas the practice of referencing market capitalization was in place before the 2008 SEC speech, the Working Group believes the SEC staff's views increased the usage of the market capitalization reconciliation and it became more prevalent in audits of such entities. Since that time the FASB issued FASB ASU 2011-08. In the Basis for Conclusions of ASU 2011-08, the FASB noted that the use of the qualitative screen will result in companies applying judgment on when and how to perform the market capitalization reconciliation[6]. Notwithstanding the potential difficulty, the Working Group believes it is a best practice to perform an analysis of the conclusion relative to the market capitalization.

[6] BC34. The Board recognizes that many public entities reconcile the sum of the fair values of each reporting unit to the entity's market capitalization. The Board acknowledged that the amendments in this Update may result in entities applying more judgment about when and how to perform this evaluation; however, it concluded that this factor should not prohibit an entity from utilizing the qualitative assessment.

The working group believes that, for publicly traded entities, in most cases it would be beneficial to perform a comparison of the estimated fair values of the reporting units in aggregate with the entity's market capitalization and analyze the implied MPAP, if any. In such cases, the reasonableness of the implied MPAP should be supported through quantitative and qualitative analyses. The rigor of the supporting analyses and documentation will depend upon the magnitude of the implied control premiums. The working group believes that the majority of the implied premium will likely be supported through the enhancement in cash flows or reduction in risk (or both), as discussed previously. The illustrative example presented in a subsequent section of this Valuation Advisory provides a potential quantitative framework that may be considered to support the implied premium. Additionally, the qualitative factors discussed in the earlier section – Business Characteristics Influencing Market Participant Acquisition Premium – may be considered to support the implied MPAP relative to the range of observed premiums from the transaction data that may be applicable for the subject entity. In certain situations, albeit rare, what appears to be an implied MPAP may result from transactions in the company's stock that are not orderly; e.g., a distressed sale[7]. This would render the comparison between the market capitalization and the estimated fair value to be not very meaningful.

The Working Group believes that use of techniques like those described above is a vital part of measuring the fair value of controlling interests in business enterprises. These tests of reasonableness allow the valuation specialist to demonstrate to auditors, regulators, and other interested parties that the MPAP is grounded in identifiable incremental economic benefits available to the relevant pool of market participants, thereby increasing the relevance and reliability of the associated fair value measurement.

The Working Group has included an illustrative example for analyzing the reasonableness of MPAPs (see *Assessing the Reasonableness of Market Participant Acquisition Premiums – Example*; a subsequent section of this paper located on page 43).

[7] ASC 820-10-35-54D

THE FAIR VALUE CONTEXT

Valuation is context dependent. Valuation specialists refer to standards of value to define the relevant context for valuation. The objective of this working group is to develop best practices for the valuation of controlling interests in business enterprises under the standard of fair value for financial reporting. The following sections of this Valuation Advisory provide commentary on the definition of fair value and identify the most common instances in financial reporting requiring measurement of the fair value of controlling interests in business enterprises.

The Fair Value Definition

Accounting Standards Codification Topic 820, *Fair Value Measurement* ("ASC 820") defines fair value as "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

The definition of fair value and associated guidance create a unique lens through which to view the valuation of controlling interests in business enterprises. A comprehensive and detailed review of the fair value definition is beyond the scope of this Valuation Advisory, and the Working Group assumes that readers have a basic understanding of the standard. However, given the fundamental significance of fair value to the subject of this Valuation Advisory, it is important to briefly review a number of key fair value concepts.

Exit Price

Fair value is defined as the price received to sell an asset; in other words, fair value is an exit price from the perspective of the owner of the asset. In contrast, an entry price would be the price paid to acquire an asset. Despite the conceptual distinction, entry and exit prices for a subject controlling interest in a business enterprise may often be indistinguishable. Nonetheless, valuation specialists should: acknowledge that the objective of a fair value measurement is to determine the exit price as of the measurement date and be alert for situations in which the exit and entry prices may differ.

Market Participants

ASC 820 defines market participants as buyers and sellers in the principal (or most advantageous) market for the subject asset. Market participants are assumed to possess sufficient knowledge regarding the subject asset. In other words, the market participant is competent to assess and understand information regarding the subject asset that would be obtained through usual and customary due diligence. This attribute of the market participant also implies that the subject asset has had appropriate exposure to the relevant market. Second, market participants have the ability, or financial wherewithal, to engage in a transaction involving the subject asset. In other words, market participant acquirers are not subject to external financial constraints that would impinge upon their ability to purchase the subject asset. Market participants are, however, subject to the internal financial constraint of rational economic behavior and the requirement that expected return be commensurate with perceived risk. Finally, market participants are willing to transact for the subject asset. Market participant acquirers for a controlling interest are motivated to transact by potential financial returns, but are not under any external compulsion or force.

Fair value is to be measured from the perspective of market participants, and valuation inputs observed directly from the behavior of market participants are given greater weight than those that are unobservable. Even when specifying unobservable inputs, valuation specialists are required by the guidance in ASC 820 to make assumptions consistent with the assumptions market participants would make, not necessarily those of the reporting entity.

The Working Group elected to introduce the MPAP in this Valuation Advisory, in part, to emphasize the importance of market participant perspectives when measuring the fair value of a controlling interest in a business enterprise.

Highest and Best Use

The fair value of non-financial assets (such as controlling interests in business enterprises) is measured with respect to the highest and best use of the assets, as that use is evaluated from the perspective of market participants. ASC 820 states that the value of non-financial assets may be maximized by their use (1) in conjunction with other assets and liabilities (previously referred to as the "in use" valuation premise), or (2) on a standalone basis (previously referred to as the "in exchange" valuation premise).[8] ASC 820 stipulates that, when measuring the fair value of a non-financial asset, the asset's highest and best use should be evaluated from a market participant perspective, even if such use differs from than intended by the reporting entity. The assumed highest and best use of the asset should be physically possible, legally permissible, and financial feasible.

[8] ASU 2011-04 clarifies that the concepts of "highest and best use" and "valuation premise" do not apply to financial assets or liabilities.

Asset Characteristics

Fair value measurement should incorporate those characteristics of the subject asset, such as condition and location, that market participants would consider in valuing the asset. With respect to an ownership interest in a business enterprise, the degree of control vested in the interest is a relevant characteristic that would be considered by market participants, and should therefore be reflected when measuring fair value. Transaction costs incurred to transact in the principal (or most advantageous) market are not characteristics of the subject asset and hence should not be considered when measuring fair value.

ASC 820 clarifies, however, that entity-specific assumptions that are not consistent with the market participant perspective, are in no case relevant to fair value measurement.

Principal (or Most Advantageous) Market

According to ASC 820, the assumed transaction underlying the fair value measurement occurs in the principal market for the subject asset. The principal market is the market with the greatest volume and level of activity for the asset. Further, the principal market is one to which the reporting entity has access at the measurement date. In the absence of a principal market, ASC 820 specifies that fair value should be measured as the price in the market in which the price received to sell the subject asset is maximized (the most advantageous market).

With respect to controlling interests in business enterprises, the Working Group believes that the principal market is that for mergers and acquisitions, in which strategic, financial, and conglomerate buyers evaluate controlling interests in business enterprises with a view toward the economic benefits expected from ownership of such interests in the context of the perceived risk and expected rewards of the investment.

Fair Value Measurements of Controlling Interests in Business Enterprises

As noted in the previous section, the relevance of a valuation adjustment such as the MPAP in measuring fair value is determined by the characteristics of the subject asset that would be considered by market participants in valuing the asset. The defining boundaries of the subject asset are delineated with respect to the unit of account, defined in ASC 820 as "the level at which an asset or liability is aggregated or disaggregated in a Topic for recognition purposes."

The Working Group has identified three instances in which the unit of account might be a controlling interest in a business enterprise: goodwill impairment testing, portfolio valuation, and application of the acquisition method to step transactions.

Goodwill Impairment Testing

The Working Group observes that goodwill impairment testing is the most common fair value measurement on a controlling interest basis. Accounting Standards Codification Topic 350, *Intangibles – Goodwill and Other* ("ASC 350") provides guidance regarding periodic goodwill impairment testing. The unit of account for such testing is the reporting unit, which is defined as an operating segment or one level below an operating segment (i.e., a component). Among the attributes of an operating segment are that it engages in business activities from which it may earn revenues and incur expense. In other words, the conduct of an operating segment can be measured in the form of discrete financial information that is regularly reviewed by the chief operating decision maker in assessing performance and allocating resources. In short, the unit of account is a business enterprise.

Consistent with the unit of account, ASC 350 acknowledges that the fair value of a controlling interest in a reporting unit may exceed the Foundation. Topic 350 explicitly acknowledges the relevance of valuation premiums when measuring the fair value of reporting units. Using the terminology adopted in this Valuation Advisory, an MPAP may be appropriate when measuring the fair value of a reporting unit. Topic 350 states:

"Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that give it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit."

Portfolio Valuation

Investment companies such as private equity funds, hedge funds and venture capital funds are generally required to report the fair value of investment holdings in accordance with Accounting Standards Codification Topic 946, *Investment Companies* ("ASC 946"). The funds of these companies often own assets which would be valued using Level 3 inputs under the fair value hierarchy established by FASB ASC 820 because current market prices are not readily available. As a result, in estimating the fair value of these assets, the issues of control and MPAP are often considered. Due to the often complex ownership structures of the underlying companies as well as relationships amongst the investors, the Working Group believes that understanding control and the related effect on fair value can be particularly challenging for these investments.

In addition to the guidance that is provided below, the Working Group would encourage the valuation analyst working in this area to read and understand the concepts outlined in the AICPA Guide "Valuation of Privately-Held-Company Equity Securities Issued as Compensation" (currently issued in draft). In particular Chapter 7 "Control and Marketability" which discusses many of the issues encountered when studying control in a capital structure with multiple owners and classes of equity. However, the Working Group notes that this guide has been published for a different purpose.

Consistent with the guidance in ASC 820, the Working Group believes that consideration of an MPAP is appropriate when measuring the fair value of a controlling interest owned by an investment company because (1) the application of an MPAP reflects the characteristics of the asset being measured (i.e., a controlling interest) and (2) market participants acting in their "economic best interest" would consider an MPAP when transacting for the asset. The Working Group also believes that the existence of an MPAP is not inconsistent with guidance found in

ASC 946. In addition, the price at which an investment company acquires a controlling interest in a private company often implies a premium to the fair value of a minority interest in the subject entity. Upon exiting the investment through a sale to other market participants, the investment company generally expects the price received to reflect a comparable premium.

Even in situations where an investment company has a minority investment, the investment company often has different contractual rights, such as information rights, rights to a board seat, right of first refusal, tag-along and drag-along rights, which many not be available to the typical minority shareholder. In addition, the investment companies typically have access to a principal exit market that is broader than available to other minority holders. In other words, investment companies often view other investment companies as part of their principal exit market. These unique rights and privileges of an investment company often warrant special considerations in the application of an MPAP. For instance, the information rights of an investment company would allow it to take a potential buyer though a due diligence process that is typically not available to other minority shareholders. The MPAP may result from the difference in perspectives between the former and the latter.

In understanding control and the related acquisition premium in the context of an investment company, there are several unique items to consider. The Working Group has identified some that it is aware of and the considerations and best practices below.

- *Ownership Among Funds of the Same Investment Company*. It is not uncommon for an investment company to manage multiple funds. It is also not uncommon for the investment company to invest in a company through multiple funds in its portfolios. In the consideration of the rights and privileges associated with the ownership position of the investment company it is important to consider the collective position of the investment company rather than the specific position of an individual fund. It is expected that the investment company will exit the ownership position in the portfolio company in a manner that maximizes the economic value and that they will recognize value in individual funds pro rata to the collective value of their investments. The Working Group believes that valuation specialists should also consider the manner in which the investment company has typically invested and divested its investments historically. A demonstrated history of collective divestments of ownership interests in a portfolio company would further support the notion that it is important to consider the collective position of the investment company rather than the specific position of an individual fund.

- *Private Equity Club Deals.* Related to the concepts outlined in the paragraph above, the Working Group recognizes that in many cases an investment company will enter into transactions as part of a group of other investment companies. These are more commonly known as “club deals” and are recognized by the similar level and type of ownership displayed by multiple investment companies. In these instances, outright control may not be possessed by any one company but control is in effect created by the consortium of investment companies working collectively. When measuring the fair value of an investment for one investment company, the Working Group believes that the relevance of an MPAP should be considered as if the ownership position was the total of all the investment companies considered part of the club deal. Again, a demonstrated history of collective divestments of ownership interests in a portfolio company by the consortium would further support the notion that it is important to consider the collective position of the consortium rather than the specific position of an individual investment company. We believe that this position is supported by the rights often possessed by members of the consortium. Some of these rights are discussed in greater detail in the following paragraph.

- *Drag Along Rights and Tag Along Rights and Investors.* Drag along rights allow one class of shareholder to compel the holders of one or more other classes of shares to vote their shares as directed in matters relating to the sale of the enterprise. In these cases, the Working Group believes that the investment company (if they have these rights) position should consider rights and preferences as if the drag along rights had been executed. Particularly as it relates to the ability to liquidate the company.

  Tag-along investors typically purchase an interest in a deal negotiated by another party (the lead, or other follow-on investor). This is different from tag-along rights which are typically granted by founders and key management shareholders in connection with a venture capital investment. Founders and key management shareholders typically agree that they will not sell any of their common shares in the enterprise without giving the investors the right to participate in the sale with the founder and management sellers pro rata to the investors' holdings; also referred to as co-sale rights. As it relates to tag-along investors, the Working Group believes it is important to consider the likely exit market which is often the principal market of the other controlling investors. The value paid by the tag along investor is often the same as other more significant investors. The valuation analyst should consider whether these other investors would compensate the less significant investor at the fair value of their investment based on factors such as the type and rights of the security and the total number of possible investors that comprise the exit market.

- *Market Participants and Exit Market.* It is important to consider who the market participants are as of the measurement date and whether the price paid by such market participants for the subject interest in an orderly transaction would include an MPAP. In practice, the market participants for a controlling interest in a private company are other private equity firms or strategic buyers. In contrast, the market participants for a non-controlling interest in a portfolio company are usually other members of the ownership consortium. These market participants have a pre-existing ownership interest in the portfolio company and/or a business relationship with the other members of the ownership consortium. The Working Group believes that a number of factors may inform whether valuation specialists should consider an MPAP in either case, including: (1) the type of market participants, (2) the existence of tag-along and/or drag-along rights, (3) the nature and magnitude of the assumed or implied MPAP paid by the ownership consortium at acquisition, and (4) the nature and magnitude of implied MPAPs historically received by the private equity fund when disposing of other similar investments.

Discussion question regarding lines 939 - 1042:

Are the concepts in the preceding section consistent with the AICPA Technical Practice Aids TIS Section 6910.34 and TIS Section 6910.35 regarding Investment Companies (issued February 2013). Please elaborate.

Acquisition Method for Step Transactions

ASC 805 prescribes the accounting treatment for business combinations achieved in stages (referred to as step transactions). For such transactions, the relevant guidance requires the acquirer to recognize all of the identifiable assets and liabilities of the target, as well as the non-controlling interest in the target at fair value.

For example, if in the initial step of the transaction, the acquirer purchases 60% of the outstanding shares of the target, the acquirer is required to measure the fair value of the non-controlling interest held by others (the 40% interest not acquired). The fair value of the non-controlling interest affects the measurement of goodwill (or gain from bargain purchase) at the transaction date.

When a non-controlling interest is present in a transaction, the fair value of that interest will reflect a potential reduction in value from the *pro rata* share of the value of the business on a controlling interest basis. As noted in ASC 805: “The acquirer usually is the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.” If the market participant for the non-controlling interest is not expected to have access to the full range of incremental economic benefits anticipated by the controlling interest acquirer, the fair value of the non-controlling interest should reflect the associated decrement to value. Incremental return requirements for a market participant evaluating a non-controlling interest would likewise be expected to reduce the fair value of the non-controlling interest.

Whether the fair value of the non-controlling shares is measured directly or through adjustment of the corresponding fair value measurement of the controlling interest, the difference between the two fair value measurements should be supported following the best practices for MPAPs set forth in this Valuation Advisory.

ASSESSING THE REASONABLENESS OF MARKET PARTICIPANT ACQUISITION PREMIUMS – EXAMPLE

The higher the premium, the greater the necessary support of the MPAP. For example, further consideration might be warranted when management identifies significant improvements in support of an MPAP but has no plans to implement strategies to achieve that higher value; such as by improving the operating performance or selling the reporting unit.

The following example is provided to illustrate best practices in assessing the reasonableness of MPAPs implied by a fair value measurement in accordance with ASC 820.[9]

Conglomerate, Inc. has a majority-owned subsidiary, Subject Co., which is determined to be a reporting unit for purposes of complying with ASC 350. The shares of Subject Co. that are not owned by Conglomerate are listed on a public exchange. At the date of Conglomerate's goodwill impairment test, the shares of Subject Co. traded at $10.00 per share, implying a market value of invested capital ("MVIC") of $4,716. A discounted cash flow analysis reflecting consensus market participant expectations for investors in non-controlling shares of Subject Co. is presented in Exhibit A. The following table summarizes some of the key metrics underlying this forecast.

Expected 5-yr Compound Annual Revenue Growth	6.5%
Gross Profit Margin	60.0%
Operating Expenses:	
Research & Development	5.0%
Distribution Expenses	14.5%
Selling Expenses	17.5%
Other General & Administrative	7.5%
EBITDA Margin	15.5%
Weighted Average Cost of Capital	10.0%
Marketable Non-Controlling Multiples	
MVIC / Trailing Revenue	0.8
MVIC / Trailing Revenue	5.1

Management of Conglomerate, Inc. has estimated the fair value of Subject Co. for Step 1 of the annual goodwill impairment test using a discounted cash flow technique. Consistent with the guidance in ASC 820, the assumptions underlying the discounted cash flow fair value analysis reflect the perspective of a market participant for a controlling interest in Subject Co. As shown on Exhibit B, the indicated fair value of Subject Co. is $15.46 per share.

The concluded fair value of Subject Co. implies an MPAP of 54.6% relative to equity, or 34.7% on a total invested capital basis.

[9] The assumed fact pattern was selected to provide the greatest clarity and ease of exposition. Practitioners are unlikely to encounter such circumstances; however, the Working Group believes the presentation applies to a broad range of situations.

	Fair Value
Total Invested Capital Value	**$6,354**
Interest-Bearing Debt	1,716
Equity Value	$4,638
Shares Outstanding	300.0
Fair Value per Share	$15.46
MPAP (Equity)	54.6%
MPAP (TIC)	**34.7%**

Tools for assessing the reasonableness of the MPAP are described in the remainder of this section. These analyses are illustrative; in many cases, one or more measures will be unnecessary or not meaningful for a particular analysis.

Economic Factors Influencing Market Participant Acquisition Premium

Ultimately, the incremental fair value associated with control (over a Foundation value) is attributable to either enhanced cash flows or a lower required return. Cash flow synergies include cost savings (manifest in higher profit margins) and/or revenue synergies (manifest in higher growth rates).

The following table compares the metrics underlying the fair value measurement of Subject Co. with those applicable to the Foundation (i.e., the publicly traded shares).

	Marketable Non-controlling	Fair Value
Expected 5-yr Compound Annual Revenue Growth	6.5%	8.0%
Gross Profit Margin	60.0%	60.0%
Operating Expenses:		
Research & Development	5.0%	5.0%
Distribution Expenses	14.5%	13.5%
Selling Expenses	17.5%	17.5%
Other General & Administrative	7.5%	7.0%
EBITDA Margin	15.5%	17.0%
Weighted Average Cost of Capital	10.0%	9.8%
Total Invested Capital Value	$4,715	$6,354
TIC / Trailing Revenue	0.8	1.1
TIC / Trailing EBITDA	5.1	6.8

Examining the table above reveals that the MPAP arises from three factors: (1) greater expected revenue growth, (2) operating expense savings, and (3) a lower weighted average cost of capital. In order to assess the reasonableness of the concluded MPAP, the analyst must assess whether market participants would use these three assumptions.

Expected Revenue Synergies

The companies referenced to determine the market participant's characteristics include some that are substantially larger than Subject Co. At the measurement date, Subject Co. distributes its product throughout the eastern United States. The pool of companies used to establish a market participant perspective included both competitors and sellers of complementary products with nationwide distribution. Conglomerate management believes that such market participants would be able to more rapidly expand Subject Co.'s marketing area, resulting in more rapid revenue growth. The expected revenue growth implies that Subject Co. will maintain market share in its existing trade area while gaining a much smaller share of the new territories.

Expected revenue synergies would likely be more difficult to support for companies that are among the largest in their respective industries or currently distribute to all relevant markets.

As demonstrated on Exhibit C, excluding other factors, the expected revenue synergies generate an MPAP of 8.7% (13.7% on an equity basis).

Operating Expense Savings

The cash flow forecast supporting the conclusion of fair value also assumes that a market participant would anticipate generating higher EBITDA margins through expense savings. Conglomerate management has identified two sources of potential expense savings, distribution expenses and corporate overhead.

The expected distribution expense savings correlate to the revenue synergies discussed above. Several market participants would be able to combine at least some delivery routes with their own, pushing down the per unit distribution cost modestly. In addition, market participants would likely be able to identify redundant corporate overhead costs, particularly in the areas of accounting and human resources.

The reasonableness of expected operating expense savings is best evaluated by comparing the projected margins with those of market participants. As shown below, the forecasted EBITDA margin of 17.0% is well within the range of margins generated by the group of comparable public companies.

Market Participant (Control)	17.0%
Market Participant (Minority)	15.5%
Margin Enhancement	1.5%
Company A	18.0%
Company B	17.5%
Company C	19.0%
Company D	17.0%
Company E	13.0%

If Subject Co.'s existing EBITDA margin was 20.0%, it would be more difficult to support the reasonableness of market participant expectations for expense savings.

Ignoring other factors, the expected operating expense savings generate an MPAP of 21.0%, or 33.0% on a total invested capital basis (see Exhibit D).

Lower Weighted Average Cost of Capital

Conglomerate, Inc. also believes that market participants would apply a modestly lower weighted average cost of capital to the projected cash flows of Subject Co., which has a sub-optimal capital structure due to excess financial leverage. Subject Co.'s higher borrowing rate and the attendant costs of financial distress reflected in the cost of equity contribute to a weighted average cost of capital that exceeds that of a market participant. As shown on Exhibit E, the assumed reduction in the weighted average cost of capital (0.20%) generates a small MPAP of 4.9% on an equity basis, or 3.1% on a total invested capital basis

There is a diversity of opinion regarding the degree to which a market participant acquirer's potentially more favorable cost of capital due to size considerations should affect the fair value of a business, or a reporting unit. However, to the extent that market participants would move away from the explicit size premium of the reporting unit, this contributes to MPAP.

Comparison of Implied Multiples to Comparable Public Companies

The following table summarizes relevant performance and valuation measures for the group of comparable public companies.

Guideline Public Company Data

	LTM Revenue	LTM EBITDA	Projected EBITDA Margin	Est. 5-Yr Revenue Growth	Market Value (Invested Capital)	MVIC / Revenue	MVIC / EBITDA
Company A	$29,000	5,220	18.0%	6.0%	$31,320	1.08	6.0
Company B	$5,100	893	17.5%	10.0%	$6,248	1.23	7.0
Company C	$13,200	2,508	19.0%	7.2%	$13,794	1.05	5.5
Company D	$2,400	408	17.0%	5.0%	$2,040	0.85	5.0
Company E	$9,000	1,170	13.0%	-2.0%	$5,265	0.59	4.5
MEDIAN	**$9,000**		**17.5%**	**6.0%**		**1.05**	**5.5**
AVERAGE	**$11,740**		**16.9%**	**5.2%**		**0.96**	**5.6**
Subject Company							
Non-controlling	$6,000	930	15.5%	6.5%	$4,715	0.79	5.1
Fair Value	$6,000	930	17.0%	8.0%	$6,354	1.06	6.8

The fair value of Subject Co on a controlling interest basis implies TIC / Revenue and TIC / EBITDA multiples of 1.06x and 6.8x, respectively. The multiple of revenue approximates the guideline median, while the trailing EBITDA multiple exceeds the guideline median, but is still within the range of the observed multiples. Taking into account differences in size, historic margins, and expected revenue growth, comparison of the implied multiples to the comparable public companies supports the overall reasonableness of the fair value measurement (and by extension the implied MPAP).

Comparison of Implied Multiples to Comparable Transactions

Management identified three transactions near the measurement date involving comparable companies. The following table summarizes relevant performance and valuation measures for the acquired companies.

Guideline Transaction Data	**LTM Revenue**	**LTM EBITDA**	**EBITDA Margin**	**Est. 5-Yr Revenue Growth**	**Transaction Value (TIC)**	**MVIC / Revenue**	**MVIC / EBITDA**
Company F	$4,500	788	17.5%	4.0%	$5,513	1.23	7.0
Company G	$7,800	1,248	16.0%	8.0%	$9,360	1.20	7.5
Company H	$9,000	1,170	13.0%	5.0%	$7,020	0.78	6.0
MEDIAN	**$7,800**		**16%**	**5.0%**		**1.20**	**7.0**
AVERAGE	**$7,100**		**16%**	**5.7%**		**1.07**	**6.8**
Subject Company							
Fair Value	$6,000	930	17.0%	8.0%	$6,354	1.06	6.8

The implied multiples for Subject Co are within the range of observed multiples for comparable change of control transactions, which supports the reasonableness of the implied MPAP.

Comparison to Observed Control Premiums

Comparing the implied MPAP to that observed in similar transactions is often appropriate; however, such comparisons should be made very carefully.

Observed control premiums (using an Equity Foundation, as traditionally stated) for the three transactions noted above range from 21.7% to 58.7%, as shown below.

Guideline Control Premiums

	Transaction Price Per Share	Shares Outstanding	Transaction Value (Equity)	Interest Bearing Debt	Transaction Value (TIC)	Unaffected Price Per Share	Observed Control Premium (Equity)	Observed Control Premium (TIC)
Company F	$36.50	55.1	$2,013	3,500	$5,513	$30.00	21.7%	7.0%
Company G	$61.00	153.4	$9,360	0	$9,360	$45.00	35.6%	35.6%
Company H	$25.00	280.8	$7,020	0	$7,020	$15.75	58.7%	58.7%
MEDIAN							**35.6%**	**35.6%**
AVERAGE							**38.7%**	**33.7%**
Subject Company								
Fair Value	$15.46	300.0	$4,638	1,716	$6,354	$10.00	54.6%	34.7%

This example demonstrates that relying only on observed transaction premiums to support a concluded or implied MPAP is potentially misleading.

Since such premiums have traditionally been expressed as a percentage of Equity Foundation, differences in leverage between Subject Co. and the acquired companies can produce unreliable fair value measurements. For example, Company F is highly leveraged, causing the observed premium using an Equity Foundation to be materially higher than when expressed as a percentage TIC Foundation. When sufficient data is available to permit the calculation, expressing premiums as a percentage of invested capital provides a more reliable basis of comparison across companies and is consistent with best practices. When expressed on a total invested capital basis, the implied premium for Subject Co is 34.7%.

If an analyst compared the equity-based MPAP for Subject Co to that of Company G (54.6% to 35.6%), the analyst might conclude that the fair value of Subject Co is overstated. However, on a total invested capital basis, the implied MPAP for Subject Co is consistent with that for Company G.

Each acquiree presents a different set of potential control benefits that may or may not be comparable to those of Subject Co. For example, Company H reported a historic EBITDA margin of 13%, below that of Subject Co and at the low end of the public peer group. The relatively low margins of Company H likely correspond to superior cash flow enhancement opportunities, and therefore a higher MPAP. In this instance, applying an MPAP equal to the transaction premium observed for Company H to Subject Co would potentially result in an overstatement of fair value.

However, as discussed earlier, observed transaction premium data may be valuable. The observed transaction premiums provide a composite view of the control benefits of cash flow enhancements and / or lower required returns perceived by the acquirers in the observed transactions. This is an important perspective and helps establish the reasonableness of the cash flow benefits assumed (or implied) by the fair value measurement under consideration. However, exclusive reliance on observed transaction premiums without careful analysis of relative financial performance, valuation multiples and other metrics can result in an unreliable fair value measurement.

SUMMARY

In fulfilling its mandate to provide best practices in the context of measuring fair value for financial reporting purposes, the Working Group has elected to introduce the term market participant acquisition premium, or MPAP. MPAP is defined here as the difference between (i) the *pro rata* fair value of the subject controlling interest and (ii*) its foundation.* The Working Group believes that valuation specialists most commonly associate the *foundation* with the *pro rata* fair value of marketable, non-controlling interests in the enterprise. While this describes an MPAP Equity Foundation concept, a Total Invested Capital ("TIC") Foundation may be more appropriate sometimes. The Working Group believes that best practices include expressing as well as applying the MPAP in the context of a TIC Foundation.

The Working Group believes that MPAPs should be supported by reference to either enhanced cash flows or a lower required return from a market participant perspective. The Working Group anticipates such benefits will not in all instances be reliably identifiable, in such cases resulting in either no, or a small, premium. Notwithstanding the emphasis on cash flow and risk differentials in supporting MPAPs in fair value measurement, the Working Group acknowledges the merit of analyzing historical data regarding observed premiums from closed transactions.

However, the Working Group cautions that exclusive reliance on observed premium data from completed transactions provides, in most cases, insufficient support for a concluded MPAP. Nonetheless, observed transaction premium data may be valuable. Certain key points regarding the observed premium data are pointed out that indicate a greater need for detailed analysis. Exclusive reliance on observed transaction premiums without careful analysis of the subject entity's relative financial performance, valuation multiples and other metrics can result in an unreliable fair value measurement.

Various business characteristics are discussed that influence an MPAP, including characteristics of the market and industry as well as both the subject entity and market participants. The prerogatives of control may lead to economic benefits in many areas and the valuation specialist should review the typical business characteristics likely to influence the magnitude of the benefits available to market participant acquirers of a controlling interest. The Working Group believes that use of the framework discussed will provide an important context for review of the valuation results, and will increase the relevance and reliability of the associated fair value measurement.

Because this Valuation Advisory is intended to address best practices for the valuation of controlling interests in business enterprises under the standard of fair value for financial reporting, certain commentary is provided regarding this context.

A credible fair value measurement should include an assessment of the overall reasonableness of the measurement, including the MPAP applied or implied by the analysis. The level of rigor of analysis would depend on the importance of the MPAP to the fair value measurement. Techniques are offered to evaluate the reasonableness of the fair value measurement of a controlling interest in a business enterprise. Additionally, an example is provided.

EXHIBITS A THROUGH E

EXHIBIT A

Market Participant Perspective - Minority Interest

Compound Annual Growth Rate (Revenue, Through Year 5): 6.5%

	Trailing		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Residual
Revenue	$6,000		$6,450	$6,902	$7,350	$7,791	$8,220	$8,631	$9,019	$9,380	$9,708	$9,999	$10,298
Revenue Growth			*7.5%*	*7.0%*	*6.5%*	*6.0%*	*5.5%*	*5.0%*	*4.5%*	*4.0%*	*3.5%*	*3.0%*	*3.0%*
Gross Profit	3,600	60.0%	3,870	4,141	4,410	4,675	4,932	5,178	5,411	5,628	5,825	6,000	6,179
Operating Expenses:													
Research & Development	300	5.0%	323	345	368	390	411	432	451	469	485	500	515
Distribution Expenses	870	14.5%	935	1,001	1,066	1,130	1,192	1,251	1,308	1,360	1,408	1,450	1,493
Selling Expenses	1,050	17.5%	1,129	1,208	1,286	1,363	1,438	1,510	1,578	1,641	1,699	1,750	1,802
Other General & Administrative	450	7.5%	484	518	551	584	616	647	676	703	728	750	772
Total Operating Expenses	2,670	44.5%	2,871	3,072	3,271	3,467	3,657	3,840	4,013	4,173	4,320	4,450	4,582
EBITDA	**930**	**15.5%**	**999**	**1,069**	**1,139**	**1,208**	**1,275**	**1,338**	**1,398**	**1,455**	**1,505**	**1,550**	**1,597**
Depreciation & Amortization	286		286	302	337	377	412	451	478	513	540	562	581
EBIT	644		713	767	802	831	863	887	920	942	965	988	1,016
Taxes	258	40.0%	285	307	321	332	345	355	368	377	386	395	406
Debt Free Net Income	386		428	460	481	499	518	532	552	565	579	593	610
Incremental Working Capital		30.0%	135	135	135	132	129	123	117	108	98	87	90
Depreciation & Amortization			286	302	337	377	412	451	478	513	540	562	581
Capital Expenditures			286	400	450	500	525	541	557	574	591	609	627
Debt Free Cash Flow			293	227	233	244	276	319	356	396	430	459	474
Residual Value													6,800
Discounting Periods			0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5	9.5
PV Factor	10.0%		0.9535	0.8668	0.7880	0.7164	0.6512	0.5920	0.5382	0.4893	0.4448	0.4044	0.4044
PV DFCF			279	197	184	175	180	189	192	194	191	186	2,750

Total Invested Capital Value	**$4,715**
Interest-Bearing Debt	1,716
Equity Value	$2,999
Shares Outstanding	300.0
Fair Value per Share	$10.00
Trading Price per Share	$10.00
MPAP (Equity)	0.0%
MPAP (TIC)	0.0%

Residual Value Calculation		
Residual Debt Free Cash Flow		474
Cost of Capital	10.0%	
Estimated Residual Growth Rate	3.0%	
Residual Capitalization Rate		7.0%
Residual Value		6,800

Relative Value Measures

TIC / Trailing Revenue	0.8
TIC / Trailing EBITDA	5.1

EXHIBIT B

Market Participant Perspective - Controlling Interest

Compound Annual Growth Rate (Revenue, Through Year 5): 8.0%

	Trailing		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Residual
Revenue	$6,000		$6,600	$7,194	$7,770	$8,313	$8,812	$9,253	$9,623	$9,960	$10,259	$10,566	$10,882
Revenue Growth			*10.0%*	*9.0%*	*8.0%*	*7.0%*	*6.0%*	*5.0%*	*4.0%*	*3.5%*	*3.0%*	*3.0%*	*3.0%*
Gross Profit	3,600	60.0%	3,960	4,316	4,662	4,988	5,287	5,552	5,774	5,976	6,155	6,340	6,529
Operating Expenses:													
Research & Development	300	5.0%	330	360	388	416	441	463	481	498	513	528	544
Distribution Expenses	870	13.5%	891	971	1,049	1,122	1,190	1,249	1,299	1,345	1,385	1,426	1,469
Selling Expenses	1,050	17.5%	1,155	1,259	1,360	1,455	1,542	1,619	1,684	1,743	1,795	1,849	1,904
Other General & Administrative	450	7.0%	462	504	544	582	617	648	674	697	718	740	762
Total Operating Expenses	2,670	43.0%	2,838	3,094	3,341	3,575	3,790	3,979	4,138	4,283	4,411	4,543	4,679
EBITDA	**930**	**17.0%**	**1,122**	**1,222**	**1,321**	**1,413**	**1,497**	**1,573**	**1,636**	**1,693**	**1,744**	**1,797**	**1,850**
Depreciation & Amortization	286		286	302	337	377	412	451	478	513	540	562	581
EBIT	644		836	920	984	1,036	1,085	1,122	1,158	1,180	1,204	1,235	1,269
Taxes	258	40.0%	334	368	394	414	434	449	463	472	482	494	508
Debt Free Net Income	386		502	552	590	622	651	673	695	708	722	741	761
Incremental Working Capital		30.0%	180	178	173	163	150	132	111	101	90	92	95
Depreciation & Amortization			286	302	337	377	412	451	478	513	540	562	581
Capital Expenditures			286	400	450	500	525	541	557	574	591	609	627
Debt Free Cash Flow			322	276	304	336	388	451	505	546	581	602	620
Residual Value													9,100
Discounting Periods			0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5	9.5
PV Factor	9.8%		0.9543	0.8692	0.7916	0.7209	0.6566	0.5980	0.5446	0.4960	0.4517	0.4114	0.4114
PV DFCF			307	240	241	242	255	270	275	271	262	248	3,744

Total Invested Capital Value	**$6,354**
Interest-Bearing Debt	1,716
Equity Value	$4,638
Shares Outstanding	300.0
Fair Value per Share	$15.46
Trading Price per Share	$10.00
MPAP (Equity)	54.6%
MPAP (TIC)	34.7%

Residual Value Calculation

Residual Debt Free Cash Flow		620
Cost of Capital	9.8%	
Estimated Residual Growth Rate	3.0%	
Residual Capitalization Rate		6.8%
Residual Value		9,100

Relative Value Measures

TIC / Trailing Revenue	1.1
TIC / Trailing EBITDA	6.8

EXHIBIT C
Fair Value Assuming Only Revenue Synergies

Compound Annual Growth Rate (Revenue, Through Year 5): 8.0%

	Trailing		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Residual
Revenue	$6,000		$6,600	$7,194	$7,770	$8,313	$8,812	$9,253	$9,623	$9,960	$10,259	$10,566	$10,882
Revenue Growth			*10.0%*	*9.0%*	*8.0%*	*7.0%*	*6.0%*	*5.0%*	*4.0%*	*3.5%*	*3.0%*	*3.0%*	*3.0%*
Gross Profit	3,600	60.0%	3,960	4,316	4,662	4,988	5,287	5,552	5,774	5,976	6,155	6,340	6,529
Operating Expenses:													
Research & Development	300	5.0%	330	360	388	416	441	463	481	498	513	528	544
Distribution Expenses	870	14.5%	957	1,043	1,127	1,205	1,278	1,342	1,395	1,444	1,487	1,532	1,578
Selling Expenses	1,050	17.5%	1,155	1,259	1,360	1,455	1,542	1,619	1,684	1,743	1,795	1,849	1,904
Other General & Administrative	450	7.5%	495	540	583	624	661	694	722	747	769	792	816
Total Operating Expenses	2,670	44.5%	2,937	3,202	3,458	3,700	3,922	4,118	4,282	4,432	4,564	4,701	4,842
EBITDA	**930**	**15.5%**	**1,023**	**1,114**	**1,204**	**1,288**	**1,365**	**1,434**	**1,492**	**1,544**	**1,591**	**1,639**	**1,687**
Depreciation & Amortization	286		286	302	337	377	412	451	478	513	540	562	581
EBIT	644		737	812	867	911	953	983	1,014	1,031	1,051	1,077	1,106
Taxes	258	40.0%	295	325	347	364	381	393	406	412	420	431	442
Debt Free Net Income	386		442	487	520	547	572	590	608	619	631	646	664
Incremental Working Capital		30.0%	180	178	173	163	150	132	111	101	90	92	95
Depreciation & Amortization			286	302	337	377	412	451	478	513	540	562	581
Capital Expenditures			286	400	450	500	525	541	557	574	591	609	627
Debt Free Cash Flow			262	211	234	261	309	368	418	457	490	507	523
Residual Value													7,500
Discounting Periods			0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5	9.5
PV Factor	10.0%		0.9535	0.8668	0.7880	0.7164	0.6512	0.5920	0.5382	0.4893	0.4448	0.4044	0.4044
PV DFCF			250	183	184	187	201	218	225	224	218	205	3,033

Total Invested Capital Value	**$5,127**
Interest-Bearing Debt	1,716
Equity Value	$3,411
Shares Outstanding	300.0
Fair Value per Share	$11.37
Trading Price per Share	$10.00
MPAP (Equity)	13.7%
MPAP (TIC)	8.7%

Residual Value Calculation

Residual Debt Free Cash Flow		523
Cost of Capital	10.0%	
Estimated Residual Growth Rate	3.0%	
Residual Capitalization Rate		7.0%
Residual Value		7,500

Relative Value Measures

TIC / Trailing Revenue	0.9
TIC / Trailing EBITDA	5.5

EXHIBIT D

Fair Value Assuming Only Operating Expense Savings

Compound Annual Growth Rate (Revenue, Through Year 5): 6.5%

	Trailing		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Residual
Revenue	$6,000		$6,450	$6,902	$7,350	$7,791	$8,220	$8,631	$9,019	$9,380	$9,708	$9,999	$10,298
Revenue Growth			*7.5%*	*7.0%*	*6.5%*	*6.0%*	*5.5%*	*5.0%*	*4.5%*	*4.0%*	*3.5%*	*3.0%*	*3.0%*
Gross Profit	3,600	60.0%	3,870	4,141	4,410	4,675	4,932	5,178	5,411	5,628	5,825	6,000	6,179
Operating Expenses:													
Research & Development	300	5.0%	323	345	368	390	411	432	451	469	485	500	515
Distribution Expenses	870	13.5%	871	932	992	1,052	1,110	1,165	1,218	1,266	1,311	1,350	1,390
Selling Expenses	1,050	17.5%	1,129	1,208	1,286	1,363	1,438	1,510	1,578	1,641	1,699	1,750	1,802
Other General & Administrative	450	7.0%	452	483	515	545	575	604	631	657	680	700	721
Total Operating Expenses	2,670	43.0%	2,775	2,968	3,161	3,350	3,534	3,711	3,878	4,033	4,175	4,300	4,428
EBITDA	**930**	**17.0%**	**1,095**	**1,173**	**1,249**	**1,325**	**1,398**	**1,467**	**1,533**	**1,595**	**1,650**	**1,700**	**1,751**
Depreciation & Amortization	286		286	302	337	377	412	451	478	513	540	562	581
EBIT	644		809	871	912	948	986	1,016	1,055	1,082	1,110	1,138	1,170
Taxes	258	40.0%	324	348	365	379	394	406	422	433	444	455	468
Debt Free Net Income	386		485	523	547	569	592	610	633	649	666	683	702
Incremental Working Capital		30.0%	135	135	135	132	129	123	117	108	98	87	90
Depreciation & Amortization			286	302	337	377	412	451	478	513	540	562	581
Capital Expenditures			286	400	450	500	525	541	557	574	591	609	627
Debt Free Cash Flow			350	290	299	314	350	397	437	480	517	549	566
Residual Value													8,100
Discounting Periods			0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5	9.5
PV Factor	10.0%		0.9535	0.8668	0.7880	0.7164	0.6512	0.5920	0.5382	0.4893	0.4448	0.4044	0.4044
PV DFCF			334	251	236	225	228	235	235	235	230	222	3,275

Total Invested Capital Value	**$5,706**
Interest-Bearing Debt	1,716
Equity Value	$3,990
Shares Outstanding	300.0
Fair Value per Share	$13.30
Trading Price per Share	$10.00
MPAP (Equity)	33.0%
MPAP (TIC)	21.0%

Residual Value Calculation

Residual Debt Free Cash Flow		566
Cost of Capital	10.0%	
Estimated Residual Growth Rate	3.0%	
Residual Capitalization Rate		7.0%
Residual Value		8,100

Relative Value Measures

TIC / Trailing Revenue	1.0
TIC / Trailing EBITDA	6.1

EXHIBIT E

Fair Value Assuming Only Lower Cost of Capital

Compound Annual Growth Rate (Revenue, Through Year 5): 6.5%

	Trailing		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Residual
Revenue	$6,000		$6,450	$6,902	$7,350	$7,791	$8,220	$8,631	$9,019	$9,380	$9,708	$9,999	$10,298
Revenue Growth			*7.5%*	*7.0%*	*6.5%*	*6.0%*	*5.5%*	*5.0%*	*4.5%*	*4.0%*	*3.5%*	*3.0%*	*3.0%*
Gross Profit	3,600	60.0%	3,870	4,141	4,410	4,675	4,932	5,178	5,411	5,628	5,825	6,000	6,179
Operating Expenses:													
Research & Development	300	5.0%	323	345	368	390	411	432	451	469	485	500	515
Distribution Expenses	870	14.5%	935	1,001	1,066	1,130	1,192	1,251	1,308	1,360	1,408	1,450	1,493
Selling Expenses	1,050	17.5%	1,129	1,208	1,286	1,363	1,438	1,510	1,578	1,641	1,699	1,750	1,802
Other General & Administrative	450	7.5%	484	518	551	584	616	647	676	703	728	750	772
Total Operating Expenses	2,670	44.5%	2,871	3,072	3,271	3,467	3,657	3,840	4,013	4,173	4,320	4,450	4,582
EBITDA	**930**	**15.5%**	**999**	**1,069**	**1,139**	**1,208**	**1,275**	**1,338**	**1,398**	**1,455**	**1,505**	**1,550**	**1,597**
Depreciation & Amortization	286		286	302	337	377	412	451	478	513	540	562	581
EBIT	644		713	767	802	831	863	887	920	942	965	988	1,016
Taxes	258	40.0%	285	307	321	332	345	355	368	377	386	395	406
Debt Free Net Income	386		428	460	481	499	518	532	552	565	579	593	610
Incremental Working Capital		30.0%	135	135	135	132	129	123	117	108	98	87	90
Depreciation & Amortization			286	302	337	377	412	451	478	513	540	562	581
Capital Expenditures			286	400	450	500	525	541	557	574	591	609	627
Debt Free Cash Flow			293	227	233	244	276	319	356	396	430	459	474
Residual Value													7,000
Discounting Periods			0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5	9.5
PV Factor	9.8%		0.9543	0.8692	0.7916	0.7209	0.6566	0.5980	0.5446	0.4960	0.4517	0.4114	0.4114
PV DFCF			280	197	184	176	181	191	194	196	194	189	2,880

Total Invested Capital Value	**$4,863**
Interest-Bearing Debt	1,716
Equity Value	$3,147
Shares Outstanding	300.0
Fair Value per Share	$10.49
Trading Price per Share	$10.00
MPAP (Equity)	4.9%
MPAP (TIC)	3.1%

Residual Value Calculation

Residual Debt Free Cash Flow		474
Cost of Capital	9.8%	
Estimated Residual Growth Rate	3.0%	
Residual Capitalization Rate		6.8%
Residual Value		7,000

Relative Value Measures

TIC / Trailing Revenue	0.8
TIC / Trailing EBITDA	5.2