

Book Review:

The Economics of Business Valuation Discounts and the Competitive Risk-Return Paradigm¹

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In his self-published book, *The Economics of Business Valuation Discounts and the Competitive Risk-Return Paradigm*, Peter C. Dawson seeks to “put forth some significant departures from generally accepted valuation theory and practice” that he hopes “will serve as a catalyst to intellectual discussions of substance among and between academics and valuation practitioners that might, in turn, set in motion fundamental advances in the fields of Business Valuation, Finance, and Economics” (p. iii and p. iv). His primary target audience seems to be appraisers of minority interests in closely-held businesses, but he also addresses an academic audience by including significant quotations from academic research focused on the valuation issues he discusses in the book.

As an accounting professor who teaches the use of financial statement analysis for estimating common stock values, I initially read the text through the wrong lenses. However, once I realized that the “business valuation discounts” with which Dawson is concerned are discounts commonly applied by professional appraisers in the valuation of closely-held business interests (such as family limited partnerships), I found his discussions interesting and thought-provoking. Valuation discounts (discounts for lack of marketability, or DLOM, and variants of such discounts) are commonly applied by appraisers in practice, and Dawson’s discussions regarding the inappropriate use of such discounts are sure to encourage debate. The main contributions of this text are to remind valuation practitioners to carefully consider the assumptions that underlie the methods they apply and to challenge them to maintain independence and objectivity as they apply their valuation techniques and judgments in the valuation process.

¹ Dawson, Peter C. *The Economics of Business Valuation Discounts and the Competitive Risk-Return Paradigm*. First Edition. Peter C. Dawson, Dallas, TX, 2010. ISBN 978-0-9844919-0-2.

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Why are these contributions relevant? Dawson offers two significant reasons. First, the appraiser's independence is critical in establishing reliable or unbiased valuation estimates. Because appraisers are hired by clients who often have predetermined opinions and self-serving motives and because appraisers' livelihoods depend on earning fees from client engagements, appraisers face pressures that may lead them to act as advocates for their clients. Such advocacy usually results in biased estimates. Second, even if appraisers seek to perform their analyses with impartiality and independence, the generally accepted practice of applying a variety of discounts in estimating the value of closely-held business interests may violate the assumptions underlying the Fair Market Value Standard (FMVS) and result in undervaluations that have negative social welfare consequences. Many valuations of closely-held business interests are performed in the context of assessing transfer taxes such as the federal estate and gift taxes. Lower (over-discounted) valuations result in lower tax revenues from these transfer situations and lead to the potential for loss of national income and inequitable redistribution of wealth among taxpayers.

Dawson's concerns throughout the text seem to be pitfalls (my characterization) that practicing appraisers should be aware of. Most of these pitfalls have to do with the assumptions underlying the Fair Market Value Standard (FMVS), and Dawson concludes that discounts for lack of marketability or markets (DLOM) are not valid when the FMVS is applied. Because most appraisals of minority interests in closely-held businesses include explicit or implicit DLOM, Dawson's conclusion calls into question the reliability of these appraisal values. In this book review, I will highlight the main pitfalls Dawson addresses in the text. Before concluding my review with some suggestions for improving the text, I also comment on Dawson's thoughts on present value discount rates and an "alternative risk-return paradigm."

Pitfalls Related to the Fair Market Value Standard's Required Assumptions

Dawson quotes the American Society of Appraisers' definition of the Fair Market Value Standard (FMVS) as follows (p. 44):

the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.

Dawson emphasizes the fact that the FMVS requires a Hypothetical Transaction between Hypothetical Investors (one buying and one selling) in a Hypothetical Market that is competitive and efficient. The following pitfalls reflect several of Dawson's key reasons for stating that DLOM violate FMVS assumptions.

Pitfall #1

The Hypothetical Investor is the typical investor in minority interests in closely-held businesses. Typical does not imply actual, and appraisers must be careful to not attribute the behavior (or what they believe to be the behavior) of actual investors or actual markets to the typical investor or the Hypothetical Market. The typical investor chooses to invest in minority interests in closely-held businesses knowing that these assets are by their nature long-term oriented and less liquid than many alternative investments. As the typical investor in the

subject asset, the Hypothetical Investor appears to have some preference for long-term-oriented, less liquid assets. Therefore, illiquidity discounts are inappropriate.

Pitfall #2

The Hypothetical Investor is a rational investor. This pitfall encompasses many of the often-applied adjustments or discounts. Rational investors hold well-diversified portfolios of assets. (Remember from Pitfall #1 that the appraiser should not substitute his/her belief regarding actual investor behavior if that belief differs from assumed investor behavior under the FMVS.) Diversification eliminates “most, if not all,” (p. 52) non-systematic risks so that systematic risk is the only risk of concern for the rational investor. Thus, adjustments or discounts for non-systematic risk violate this rationality assumption. Dawson classifies the following common discounts or adjustments as being ones that represent adjustments for non-systematic risks. A discount for relative illiquidity is not valid if the subject asset is held in a well-diversified portfolio because short-term liquidity can be achieved by selling more liquid assets in the portfolio. When appraisers adjust the three critical inputs to valuation methods (i.e., projected net cash flows, the long-term growth rate, and the present value discount rate), they are introducing bias in their value estimates by making subjective adjustments based on their perception of non-systematic risk factors of the subject asset. SGLPTL³ adjustments are subjective adjustments to guideline company market multiples that result in layers of erroneous discounting because these adjustments to numerous multiples, like the adjustments made to valuation method inputs, reflect appraisers’ analysis of underlying differences in non-systematic risks between the guideline companies and the subject asset.

Pitfall #3

The Hypothetical Transaction is a current transaction between a willing buyer and a willing seller; therefore, total current transactions costs should be considered, and the current Hypothetical Buyer’s expected future selling transactions costs (to be incurred to achieve future liquidity) are irrelevant. The future selling costs are irrelevant because the current Hypothetical Seller would not be willing to negotiate costs of a transaction in which he/she won’t be involved. Dawson illustrates graphically that, even if these future selling costs were relevant, the downward shift in the demand curve resulting from the Hypothetical Buyer’s desire to be compensated for his/her expected future selling transactions costs results in only partial compensation when the supply curve remains stationary. This partial compensation would be considered a DLOM, but it is smaller than the DLOM would be if full compensation were allowed. (See Chapter 7 for this analysis.) Because the full picture isn’t developed at this point, readers must continue on to Chapter 13.

The current Hypothetical Transaction involves both Hypothetical Buyer and Seller, so demand and supply affect market equilibrium and the fair market value of the asset. Dawson’s graphical analysis of the impact of total current transactions costs (which incorporate the costs

³ Dawson states that “the SGLPTL financial variables are: Size, Growth in profitability, Leverage, Profitability, Turnover, and Liquidity” (p. 121).

of relative illiquidity for minority interests in closely-held business assets) on the equilibrium fair market value reveals a value that incorporates a small premium for lack of marketability (PLOM), not a discount! This is probably the most controversial conclusion in the text, and it is driven by the strict application of the FMVS assumptions in the economic market analysis including the Hypothetical Seller in addition to the Hypothetical Buyer. Dawson's exposition and illustrations in Chapter 13 carefully and convincingly guide the reader through his analysis to his PLOM conclusion. The following components are critical in this analysis: both the Hypothetical Buyer and Seller are rational, willing, and well-informed; both face present transactions costs, but the Hypothetical Seller's transactions costs exceed those of the Hypothetical Buyer; and both negotiate for compensation of their own transactions costs with equal bargaining power. The PLOM result reflects the incidence of the total transactions costs – the Hypothetical Buyer's portion of the total costs (due to relative illiquidity) are included in the Hypothetical Market equilibrium price or fair market value.

Dawson also addresses several other discount-related practices that appraisers often apply. He provides reasons why these practices violate FMVS assumptions. Dawson has certainly tried to anticipate readers' objections to his assertions and analyses, and he artfully uses citations from academic research to enhance and support his discussions. Dawson's primary objective in the text seems to be offering reasons that DLOM are not valid in estimating the values of minority interests in closely-held business assets, so he also includes additional thoughts and analyses regarding present value discount rates and competitive risk-return paradigms.

Present Value Discount Rates and Competitive Risk-Return Paradigms

According to Dawson, the application of the DLOM in practice is based on the assumption that the Hypothetical Investor demands and is able to garner a higher return for the higher risk (lower liquidity) of the minority interest in the closely-held business. As all know, the FMVS presumes a competitive Hypothetical Market. Accordingly, as all know, the competitive asset market risk-return relationship is important. Dawson depends on the tenet of the Traditional Capital Asset Pricing Model (CAPM) that diversification eliminates non-systematic risk so that only systematic risk is priced. (See Pitfall #2.) He reminds the reader that the CAPM reflects a positive risk-return relationship, and he attributes the common practice by appraisers of applying DLOM to the incorrect characterization of risk (total risk instead of only systematic risk) in the application of this positive relationship. However, Dawson also challenges his readers to consider present value discount rates and the positive risk-return relationship in a more unconventional way. Dawson's discussions of these issues are in Chapters 6 and 14 through 16.

As an accounting professor who is accustomed to using the CAPM to estimate a cost of equity capital rate to use in calculating expected abnormal earnings and in discounting dividends and abnormal earnings to estimate intrinsic values of common equity, this part of the text (particularly Chapter 6) was the most frustrating for me. My primary frustration was in trying to figure out how to translate Dawson's concerns into practice, and professional appraisers who read this text may experience the same frustration. Dawson seems to have three concerns with present value discount rates and their impact on DLOM. First, as

mentioned in Pitfall #2, appraisers often use an inflated discount rate because they start with a Traditional CAPM rate and then adjust that rate by adding additional premia for non-systematic or firm-specific risks. Dawson states that this violates the FMVS assumption that non-systematic risk has been eliminated by rational Hypothetical Investors through portfolio diversification. Second, Dawson expresses concern that by over-estimating the equity risk premium used in the CAPM, appraisers' valuation estimates are under-stated. Addressing these two concerns in practice is straight-forward. Third, Dawson is concerned about the characterization of the present value discount rate as the investor's required rate of return for the subject asset. Dawson emphasizes that the present value discount rate should be the market rate of return expected for the next best alternative investment and that the next best alternative investment should be identified based on marginal utility (principle of substitution) instead of being limited to an alternative with similar risk and other asset characteristics. Although Dawson's concept here is understandable and consist with the American Society of Appraisers' description of the principle of substitution (see quote on p. 157), Dawson is calling into question the American Society of Appraisers' definition of the discount rate, which states, "The discount rate is the cost of capital, or the required rate of return expected on alternative investments of equal risk and other characteristics" (p. 150). Dawson also talks about portfolio diversification based on utility, de-emphasizing diversification to eliminate non-systematic risk. Even if the reader agrees with Dawson's theory, the practical application is missing. If the appraiser should be using the Traditional CAPM to estimate the present value discount rate without additional risk premia for non-systematic risk, it seems that the beta factor in the CAPM must be where this problem lies. Dawson should provide further explanation and guidance for application.

Dawson finishes the text in Chapters 14 through 16 with a review of the Traditional CAPM and an analysis showing that a negative risk-return relationship would exist if risk-seeking instead of risk-averse investors dominate the market. His analysis emphasizes the impact of utility preferences using a price-to-risk ratio and illustrates how risk-seeking investors would push an asset's equilibrium price up above a previous equilibrium price in response to a systematic-risk-increasing shock which allows them the opportunity to earn a higher return (in the wider upper tail of the normal distribution). The result is a price premium (not discount) and lower returns for higher systematic risk. His concluding statement in Chapter 15 (p. 396) is as follows: "In the competitive Hypothetical Market, under less restrictive – and more general – assumptions about the population of Hypothetical Investors, a more likely outcome reveals itself to be a negative (zero) Fair Market discount for higher systematic risk closely-held company interests in the short-run (long-run)." Although Dawson's analysis is interesting, I find it only somewhat relevant to the rest of the text because he has indicated in several places throughout the text that the typical or Hypothetical Investor is long-term oriented and relatively risk averse. Based on this characterization of the Hypothetical Investor who is deemed to be buying in the Hypothetical Market for closely-held companies, there seems to be a very low probability that risk-seeking (short-term focused) investors would dominate even in the short-run. Again, Dawson seems to be satisfied to show another possible scenario in which a DLOM would not be applicable, but he does not offer practical suggestions for applying his conclusion in an actual appraisal.

Reviewer Suggestions

Dawson states in his preface that this self-published text “has not been subject to an independent peer review process over a sufficient period of time” (p. iii). Because I am neither an economist nor a professional appraiser, my suggestions here are ones that relate to clarity and to practicality. Dawson spends much of the text discussing apparent violations of the FMVS, so readers would greatly benefit from a definition and a description or listing of the underlying assumptions of the FMVS at the very beginning of the book. This is essential for readers who are not practitioners and would also help remind practitioners about the assumptions that Dawson says are being violated in practice. Re-organizing the chapters within the text would make this book much easier to read and to follow. Specifically, Chapter 10 – Advocacy illustrates the potential economic consequences of biased valuation estimates and should be presented at the beginning of the text. The analyses in Chapter 7 – Conventional Theory Underlying a DLOM and Chapter 13 – The Fair Market DLOM are much better understood when the two chapters are considered together than they are with five chapters separating them. Chapter 2 – Empirical Benchmark Measures of the DLOM seems to relate more to the application chapters (Chapters 9, 11, and 12) and distracts the reader from the primary issues by its placement within the text. Dawson includes considerable repetition, especially with regard to non-systematic risk adjustments applied in practice. This may be intentional because of the way Dawson addresses the commonly-applied discounts or adjustments. Finally, Dawson could strengthen the impact of this text on practice by providing more application guidance, especially with the present value discount rate discussion in Chapter 6.

Overall, Dawson has provided careful analyses and discussions that challenge professional appraisers’ common practice of applying extensive DLOM in valuing minority interests in closely-held businesses. He reminds his readers, whether practitioners or academic researchers, to pay more careful attention to common practices and to assumptions underlying those practices. I encourage professional appraisers and economists to read this text and provide an appropriate independent peer review.