LO.a: Compare public and private company valuation.

1. Which of the following *best* explains differences between public and private companies?
   A. Private companies offer higher compensation relative to public companies and consequently attract superior management.
   B. Public companies are generally more transparent in their financial reporting and more significantly impacted by taxes than private companies.
   C. In most private firms, management has a controlling ownership interest due to which decision-making takes a longer term perspective compared to public companies.

LO.b: Describe uses of private business valuation and explain applications of greatest concern to financial analysts.

2. Which of the following is *least likely* a purpose for valuing private companies? Valuation performed for:
   A. initial public offering.
   B. a share repurchase from the public.
   C. venture capital financing.

LO.c: Explain various definitions of value and demonstrate how different definitions can lead to different estimates of value.

3. The value of a company specific to a particular buyer based on his perceived risk and benefits is known as:
   A. intrinsic value.
   B. investment value.
   C. fair value.

LO.d: Explain the income, market, and asset-based approaches to private company valuation and factors relevant to the selection of each approach.

4. Firm A is a struggling company in the manufacturing industry. Demand for the company's products has declined markedly over the last two years and is unlikely to pick up again. Firm B is an established company in the dairy industry with a steady and predictable cash flow. The best way to value these companies is:
   A. asset-based valuation for Firm A and income-based valuation for Firm B.
   B. asset- based valuation for both Firm A and Firm B.
   C. asset -based valuation for Firm B and income-based valuation for Firm A.

LO.e: Explain cash flow estimation issues related to private companies and adjustments required to estimate normalized earnings.

5. Which of the following items needs adjustment when forecasting earnings of private companies?
   A. Above-market management compensation.
   B. Sales of newly launched products.

C. Unusually high raw material expenses due to inflation.

LO.f: Calculate the value of a private company using free cash flow, capitalized cash flow, and/or excess earnings methods.

6. Samball Foods is a small private food producer. The company is expected to generate FCFF of $1,200 in one year. The WACC and long-term growth rate are 15% and 5% respectively. The company has total debt outstanding of $2,000. The value of equity is *closest* to:
   A. $12,000.
   B. $6,000.
   C. $10,000.

LO.g: Explain factors that require adjustment when estimating the discount rate for private companies.

7. Which of the following adjustment is *most likely* required when estimating the cost of capital for private companies?
   A. Subtract a premium for size.
   B. Add a size premium.
   C. Lower the cost of capital.

LO.h: Compare models used to estimate the required rate of return to private company equity (for example, the CAPM, the expanded CAPM, and the build-up approach.

8. Cannon Co. is a small private leather goods' manufacturer. An analyst estimates that the beta of similar public companies is 1.1, the risk free rate is 4% and market risk premium is 6%. In addition, the small stock premium is estimated at 2% and company-specific risk premium is 1%. The estimated cost of capital using CAPM and expanded CAPM is *closest* to:
   A. CAPM 10.6%, Expanded CAPM 12.6%.
   B. CAPM 10%, Expanded CAPM 13.6%.
   C. CAPM 10.6%, Expanded CAPM 13.6%.

LO.i: Calculate the value of a private company based on market approach methods and describe advantages and disadvantages of each method.

9. Hector Lector is valuing a private company, Premium Electronics, based on market approach methods. The purpose of valuation is for a potential takeover by a large public company. Which of the following statements is *most* likely true?
   A. If the guideline public company method is used, a control premium does not need to be estimated.
   B. Under the guideline transactions method, the control premium is already incorporated in the transaction.
   C. If the prior transaction method is used, the transaction does not need to be recent or at an arm's length.

LO.j: Describe the asset-based approach to private company valuation.

10. Asset-based approach to valuing private companies is *most* appropriate when:
    A. firms have high profits and growth prospects.
    B. companies are in the financial industry.
    C. companies have a high proportion of intangible assets.

LO.k: Explain and evaluate the effects on private company valuations of discounts and premiums based on control and marketability.

11. Burger House Ltd. was recently acquired by a large food conglomerate. The transaction was completed at a 25% premium over assessed value to account for control. Sally Lim only has details of this particular transaction available to evaluate the acquisition of a minority stake in Bostin Foods, a small private food producer. The assessed value of the company based on free cash flow is $25 per share. Accounting for the discount for lack of control, the transaction value per share should *most* likely be:
    A. $20.00.
    B. $25.00.
    C. $31.25.

LO.l: Describe the role of valuation standards in valuing private companies.

12. Which of the following statements regarding compliance to valuation standards by private companies is *most likely* true?
    A. Ensuring compliance to standards can be difficult because valuation reports are mostly private.
    B. The standards are widely known by buyers and their compliance is not the appraiser's option.
    C. The compliance to standards is facilitated by the fact that all valuations are generally similar.

Solutions

1. **C** is correct. Top management has a controlling interest in most private companies. Therefore, decision making takes a longer term perspective than public company management. Private companies are more concerned about the impact of taxes on reported income than public companies. Also, public companies attract more qualified management due to their larger size and visibility. Section 2.1.

2. **B** is correct. Private companies are not listed hence their shares are not owned by the general public. Options A & C are the reasons for performing private business valuation. Section 2.2.

3. **B** is correct. The value of an investment to a particular investor based on his/her investment requirements and expectations is known as investment value. Section 3.

4. **A** is correct. As Firm A is likely to liquidated, an asset-based valuation will give an appropriate estimate of value. Firm B should be valued using the income approach because the cash flow is predictable. Section 4.

5. **A** is correct. Large managerial compensation is generally given to the owner management of private companies. When the company is acquired such items will likely be eliminated and therefore need adjustment while developing earnings estimates. Options B & C are incorrect as these items do not need any adjustment to earnings of private companies. Section 4.1.

6. **C** is correct. The value of the firm is 1200/(0.15 - 0.05) = $12,000. The value of equity is 12,000 - 2,000 = $10,000. Section 4.1.2.

7. **B** is correct. Premium for small size are added which increase cost of capital of a private company. Section 4.2.1.

8. **C** is correct. The CAPM cost of capital is 4 + 1.1(6) = 10.6%. Adding the small stock premium and company-specific risk premium gives the cost of capital from expanded CAPM as: 10.6 + 2 + 1 = 13.6%. Section 4.2.1.

9. **B** is correct. Under the guideline transactions method, the control premium does not need to be estimated separately as it is already included in the transaction. Control premium must be added to multiples under the guideline public company method. Under the prior transaction method, the transaction should ideally be recent and at an arm's length. Section 4.3.

10. **B** is correct. Financial companies might be valued using asset-based valuations as their asset and liability values are typically based on market prices. Firms with high profits and good prospects are best valued using income approach. Companies with a high proportion of intangible assets would have values understated under an asset-based approach. Section 4.4.

11. **A** is correct. The DLOC is calculated as 1 - (1/(1+0.25)) = 20%. Applying a 20% discount to the assessed value of $25 gives a transaction value of 25(0.8) = $20 per share. Section 4.5.1.

12. **A** is correct. Private valuation reports make it difficult to ensure compliance of standards. The application of standards is usually at the discretion of the appraiser as buyers are unaware of these standards. Also, the heterogeneity of valuation assumptions can lead to different conclusions of value making it difficult for an appraiser to assess compliance to standards. Section 4.6.

