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Combining Commonly-Owned Companies for Valuation Purposes

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The Question as Presented:

Is there a precedent for combining commonly-owned companies for valuation purposes when they are interdependent with numerous inter-company transactions? They were established separately for tax purposes.

The Answer

While I find no precedent for combining commonly-owned companies for valuation purposes, I find no standard indicating that this methodology is **prohibited**. For a previous valuation engagement, I was hired to value commonly-owned companies both as individual, stand alone entities and as a combined company. The values derived for both valuations were not equal and, thereby, the rationale behind performing this combined valuation became quite clear.

The value of the “entire” package (which in reality was actually the substance of the arrangement versus the form of the arrangement) was worth substantially more than the value of each individual entity. This was primarily due to allocations made to one of the commonly-owned companies. This segment of the “main” business, if valued as a stand-alone entity carried considerable higher risk than what would be warranted through combination of the companies.

One easily could contemplate a situation where the reverse would be true. For instance, imagine the following scenario: a law firm set up a leasing company to hold all of its assets that are then leased back to the law firm. There is really no value in the leasing company established given that it was uniquely designed to serve the purposes of the law firm in question, and it is unlikely that any other law firm would actually have any interest in those particular assets. As such, these two entities should be combined to produce a reliable valuation conclusion.

On the other hand, if the same law firm actually had a leasing company that financed and provided equipment, software, and technical support to other law firms in addition to providing for its own needs, there would most likely be value in that leasing company that might be lost if it were simply combined with the “owner” law firm.

The following might be considered in deciding whether to combine entities:

1. Are there majority shareholder differences between the entities that would make a joint sale unlikely or restricted?

2. If this is a marital dissolution case, sole and separate property issues could make combining unacceptable. The ramifications of combining must be considered and should be discussed with legal counsel.

3. If this is a dissenting shareholder action, there may be agreements in place or other documents that actually prohibit combining entities. These are legal matters that must be discussed with legal counsel.

We know that it is important to preserve sole and separate assets, and we know that dissenting shareholder actions frequently involve "special" legal consideration. It would be our responsibility to discuss these facts with counsel and to make an informed decision based upon counsel's interpretation of the legal issues before we decide whether combination is appropriate and defensible.

Overall, absent a situation directly prohibiting a combination, I believe that the power to combine entities for valuation purposes must be established by the engagement letter and discussed within the limiting condition statements provided by the valuation expert. That is to say, the decision to combine entities should fall in-line with the general purpose of the engagement letter. For litigation cases, it is better to get both sides to adopt a specific approach (assuming that you are not neutral in the proceedings) in order to avoid future arguments that may arise about the issue. Either way, if the decision to combine entities is not a clear-cut issue, the valuator must address this issue within the limiting condition statements included in the valuation report and must clearly state the fact that a combination will occur within the engagement letter.

Work Cited

Please call for references.