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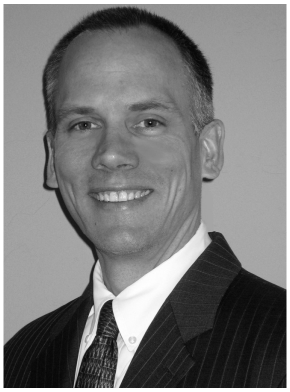
BVU PROFILES

The Challenges of Bringing a New BV Methodology Into Acceptance

Peter J. Butler, CFA, ASA, founding principal of Valtrend (Eagle, Idaho), has championed a more quantitative and empirical approach to developing the cost of capital. This approach is embodied in the Total Cost of Equity Calculator, also known as the Butler Pinkerton Calculator, which he invented and co-developed. He is also on the team that has developed the new implied private company pricing model, a calibrator for developing the cost of capital for small private companies.



'Some lessons learned with the Butler Pinkerton Calculator are being applied to the development of IPCPL/IPCPM.'

***BVU:* How did you get started in valuation?**

Pete Butler: I was always interested in stock investing. While in the Navy, I earned my MBA at night, which helped me in the transition to the civilian workforce. My first position after the Navy was working as a securities analyst, specializing in class action litigation. That firm also started a small VC fund. That was my entryway into private company valuation.

***BVU:* Do you have an area of specialty?**

PB: I consider myself a specialist in business valuation. Living in a small town, I really can't specialize within BV. I've performed valuations for estate/gift tax compliance and planning, M&A, buy-sell agreements, marital dissolution, 409A, SBA lending, and litigation support, among others.

***BVU:* What areas in valuation practice do you see as ripe for growth?**

PB: Exit/succession planning is certainly one area of growth, given the baby boom tidal wave. Appraisers would be well briefed to get on the front side of that wave, not only from the standpoint of valuing companies, but also of helping to improve the value of the company before it's sold.

I would caution appraisers who want to go into new areas to fully educate themselves before proceeding. Some of these areas, such as personal injury, for example, have experts who have been practicing for a long time. So you need to be fully versed in a new practice area, especially in the event you go up against an experienced expert, for example, in a litigation setting.

***BVU:* What do you see as a key issue in BV today?**

PB: From a business development perspective, I think it is the commoditization of the services

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and fee constraints. For example, it only takes one "qualified" appraiser in any locale to not understand the value of an assignment or what we do or how we do it to negatively influence the consuming public into thinking that an appraisal can be done for less than $1,000.

***BVU:* You invented the Butler Pinkerton Calculator, known as the BPC, which uses an empirical approach to estimating discount rates and cost of capital for private companies. What is the basic technique behind it?**

PB: The BPC stems from modern portfolio theory. It uses CAPM beta, except without the benefit of diversification. CAPM beta becomes total beta when diversification is removed. It's as simple as that. Most potential buyers of privately held companies are not well diversified. Therefore, appraisers should be looking to total betas for assistance in developing discount rates for privately held firms. Please note that I said assistance and not "TB is the be-all, end-all" to development of cost of capital.

The BPC, however, is updated daily and objectively quantifies company-specific risk premiums (CSRPs) and total cost of equities (TCOEs) for guideline publicly traded companies. Down the road, we may develop total beta indices for small-, medium-, and large-cap companies.

***BVU:* You're on the team that developed a new model, the implied private company pricing line and the implied private company pricing model.**

PB: Yes, along with Bob Dohmeyer (Dohmeyer Valuation Corp.) and Rod Burkert (Burkert Valuation). We developed a cost of capital methodology for the valuation of privately owned businesses with up to $50 million in revenue. IPCPM is powered by the implied private company pricing line (IPCPL), which uses a statistical sample of 500 small- and lower-middle-market transactions reported in the *Pratt's Stats* database. Then, with the help of Toby Tatum (Alliance Business Appraisal), we also developed a tool known as the Build-Up Method/WACC Calibrator, which is designed to calibrate your cost of capital developed with other sources (build-up method, total beta, etc.). Visit www.bvresources.com/ipcpl for more information.

We have written a number of articles on this new methodology, conducted webinars, and are now on the speaking circuit discussing it and collecting feedback.

***BVU:* IPCPL/IPCPM will have to go through an acceptance process just as the BPC did. Can you describe this process and how you were able to successfully pass a *Daubert* challenge with the BPC?**

PB: The successful response to the *Daubert* challenge was a major victory for the BPC technique. At every speaking engagement I had, it seemed that I invariably got the following questions: "Has it passed a *Daubert* challenge?" "Has a court accepted it?" Finally, I could answer in the affirmative. (*Editor's note:* The case is *Alamar Ranch LLC v. City of Boise*, 2010 WL 5055917 (D.Idaho))

Prior to that, however, it was an arduous process, to say the least. I solicited and obtained numerous positive testimonials from highly qualified and influential appraisers. This, in hindsight, was instrumental in fending off the *Daubert* challenge. Other appraisers also started analyzing and writing (either with me or on their own) their positive impressions about the technique in BV journals, for which I was very grateful. I went on the speaking circuit and appeared at every organization's national conference and many more state/regional conferences and even an international conference.

Of course, I responded to every critical article that appeared in a business valuation journal to ensure that there were no misunderstandings about the technique. Although the BPC uses a rather easy concept, there was some confusion out there.

***BVU:* In this regard, did you learn any lessons with the BPC that you are using with introducing IPCPL/IPCPM?**

PB: We are taking more time to allow the masses to become acquainted with it before we commercialize it, if that is in its future. We have given out hundreds of free trials through our LinkedIn discussions. I should mention that the Butler Pinkerton Calculator is also available for a free trial run, at www.bvresources.com/bpc.

In hindsight, some people may have misconstrued our enthusiasm for total beta (TB) and the BPC as an attack on the status quo. To a certain degree, it was, of course. But, even to this day, I still look at multiple techniques, which now might include the dubious BUM, MCAPM, TB/BPC, and the IPCPL/IPCPM, for example.

Thus, we are being less "confrontational" in rolling out IPCPM, which we call a "calibrator." It can run completely behind the scenes. As you can see, we are not asking the BV community to abandon the BUM or whatever other publicly traded stock method they are using, such as MCAPM or TB/BPC, for example. Rather, we are asking that they calibrate those indications of the appropriate cost of equity with the IPCPL/IPCPM. In summary, appraisers may feel less "threatened" by its arrival than they might have with TB/BPC.

***BVU:* Have you received any major criticisms of IPCPL/IPCPM yet?**

PB: There have been a few comments—more to understand the technique at this point than overtly critical. Interestingly, with the BPC, I didn't get any real criticisms per se until after it was commercialized. That's when the critical articles appeared that I, of course, responded to. So that same phenomenon may happen with IPCPL/IPCPM. Naturally, it would be better to get as much feedback now as we can, so we're taking our time with rolling out the model and eliciting feedback through free trials, articles, and speaking engagements.

***BVU:* Does the current BV professional environment encourage new models such as yours?**

PB: No, to put it bluntly. The most recent quotes by Professor Damodaran really resonated with me. He calls them as he sees them, which is refreshing. In an interview in the September 2014 issue of *Business Valuation Update,* he says:

> The rulewriters and gatekeepers in valuation appraisal seem to be players in the game, i.e., they are in the business of providing valuation services. I think this creates two problems. The first is a conflict of interest, where, if you have created the de facto rule for how to estimate discount rates, liquidity discounts, or control premiums, and are making money off that rule, you have little incentive to see challenges to it. The second is that it makes the process static, where change is difficult and discouraged.

Professor Damodaran "invented" total beta. He had no agenda other than to improve the status quo—which it does. I "discovered" it while reading one of his textbooks and immediately saw what a major contribution it was to the field of business valuation. The rest is history, as they say. In hindsight, unfortunately, I should have been more realistic about human nature. Some people felt threatened by it for a variety of reasons, including commercial/conflict of interest reasons as Damodaran refers to. There were also a lot of egos involved and a simple reluctance to change.

I am the first to admit that TB/BPC is not perfect. It is still, thankfully, subjective to select a CSRP or, more important, a TCOE. But what I have always found ironic is that the technique it is attempting to replace (or at least complement)—the precarious BUM—is a complete guess when it comes to selecting the company-specific risk premium, and that is after we somehow get past the alleged and dubious size premium. In other words, the hurdle rate for improvement over the BUM is a very low bar. However, given human nature, it is nonetheless a bar that happens to be a bar to advancement in the industry.

There has been a lot of complex math thrown around to allegedly refute TB. One particular ardent naysayer, for example, has made the claim that to use TB you must assume that your subject company is perfectly correlated with the market, and, of course, nothing is perfectly correlated with the market. So, this critique—on the surface—may have resonated with some.

To make a long story short, TB equals beta/correlation coefficient. Lo and behold, if the correlation coefficient is equal to 1.0 (i.e., perfectly correlated with the market), TB equals beta. Then and only then in this critic's view can anyone use TB. In summary, he does not like any other coefficient to be used as a multiplier of the equity risk premium in the CAPM equation:

$$K_e = r_f + \text{beta} * \text{equity risk premium}$$

To place any other multiplier next to the equity risk premium is a violation of the CAPM. However, TB proponents already admit that TB violates CAPM and happily apply the following equation:

$$K_e = r_f + \text{TB} * \text{equity risk premium}$$

To simplify, if appraisers accept the following assumption as reasonable, no one should have any material issues with TB's use for the valuation of privately held companies:

> In the market for small privately held businesses, buyers and sellers are relatively undiversified and, therefore, price their actual (total) risk proportionally the same as diversified investors price their actual (systematic) risk (per CAPM).

That's it. Not that much of a stretch.

If that assumption is accepted, which violates the CAPM, TB simply replaces beta in the equation above for privately held companies while not making any (implicit or explicit) assumption about correlation.

And if appraisers do not like this assumption, what assumptions are they making when they select a CSRP for a privately held company, whose mere addition violates the CAPM?

I stumbled across a quote by George Box, a famous statistician, which really sums it up:

> All models are wrong, but some are useful.

In summary, I have been using a wrong, but useful, model since 2006 when I first started using TB/BPC. I also believe that we have been using another wrong but useful model since we developed the IPCPL/IPCPM. The beauty of both techniques is that they provide benchmarking for a private company's total cost of equity (TB/BPC) or weighted average cost of capital (IPCPL/IPCPM). All other reference sources that appraisers use do not capture the most important piece of the puzzle: the company-specific risk premium.

***BVU:* What can be done to produce an environment more receptive to change?**

PB: I wish I had the answer. In a perfect world, we would not be so beholden to what has already been accepted in the courts. I cannot think of any other industry that needs the blessing of the judicial system to tell them how to do their work or advance and improve. What a sorry state that would be.

I also would love to see more collaboration among appraisers. There are a lot of egos in this industry. I think we could have avoided many of the "he said, she said" articles that only served to confuse the TB topic and, unfortunately, most likely limited its adoption, at least to date. If those against TB/BP would have picked up the phone and asked me what I meant here, or there, or just to get clarification on my views on TB, much of the alleged controversy could have been avoided.

***BVU:* That's a great point, but isn't it important to do this in a public forum in case others have the same question or issue but don't bother to ask?**

PB: That's an excellent point. That's fine as long as it's kept on an educational level and you stick with the issues rather than launching into a personal attack. Part of the problem is that many appraisers are used to being confrontational in a litigation setting, so that's the mindset.

***BVU:* Thank you for your comments and good luck with the further development of the BPC and the new IPCPL/IPCPM methodology.**

PB: Thank you.