BVR
What It's Worth
Vol. 27, No. 3, March 2021
BUSINESS VALUATION UPDATE
TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Price Versus Value: A Transaction and Litigation Perspective

By Craig A. Jacobson and Richard B. Peil, B. Riley Advisory Services (New York, N.Y., and Phoenix, Ariz., USA)

According to disciples of modern portfolio theory and its efficient market hypothesis, shares of public companies should always trade at a price equivalent to their economic value, making it impossible for investors to experience short-term arbitrage profits. In other words, an investor should be unable to purchase stock at a price below its fundamental value or sell those same shares at a price above their fundamental value.

However, explain that theory to any hedge fund manager or day trader who purchased or sold GameStop Corp. (NYSE:GME) common stock for $89 on Jan. 26, 2021, $380 on Jan. 27, 2021, $112 on Jan. 28, 2021, or $413 the following day on Jan. 29, 2021.[1] During those few days of trading, did GameStop's share price and fundamental value gyrate in tandem? Or was there some combination of external forces that created a disparity between the company's trading price and its fundamental value? We believe the answer is resoundingly the latter.

Although rare, GameStop is an extreme example of interday and intraday price fluctuations that opens the door to a broader discussion about differences between price and value. The price-versus-value topic is of particular interest to valuation professionals who are called on to value securities of privately held companies in connection with commercial litigation or bankruptcy disputes and/or prospective M&A transactions.

In a vacuum, the concept of efficient markets is an elegant theory for academic textbooks. However, in the real world of business valuation, the theory becomes very murky indeed. This article focuses on practical reasons why price and value are not always the same concepts and why they can diverge in real-world situations.

The Starting Point: Defining Price and Value?

The famous Wall Street investor, Warren Buffett, is well-known for one particular quote: "Price is what you pay, and value is what you get." It is an idea that largely described his investment philosophy and one that he used to achieve unparallel levels of success during his vaunted career. If the most prolific Wall Street investor of the 20th and 21st centuries recognized a difference between price and value, it is hard to dispute the notion.

Price seems to be the easiest concept of the two to understand. As Buffett so elegantly alluded to in his quote, price is the amount of consideration paid to acquire another asset. Price is established through the competing elements of supply and demand until an equilibrium amount is achieved in a market.

However, unless an investor purchases a $10 bill for another similar $10 bill, the concept of what the buyer received in return for that cash payment, i.e., value, can be up for debate, particularly when that buyer purchases shares in a privately owned company.

1 *Note: As we write this article on Feb. 2, 2021, GameStop's closing price has fallen to $90 per share.*

Business Valuation Update™ (ISSN 2472-3657, print; ISSN 2472-3665, online) is published monthly by Business Valuation Resources, LLC, 111 SW Columbia Street, Suite 750, Portland, OR 97201-5814. Periodicals Postage Paid at Portland, OR, and at additional mailing offices. Postmaster: Send address changes to *Business Valuation Update (BVU)*, Business Valuation Resources, LLC, 111 SW Columbia Street, Suite 750, Portland, OR 97201-5814.

The annual subscription price for the *BVU* is $459. Low-cost site licenses are available for those who wish to distribute the *BVU* to their colleagues at the same firm. Contact our sales department for details. Please contact us via email at customerservice@bvresources.com, phone at 503-479-8200, fax at 503-291-7955 or visit our website at bvresources.com. Editorial and subscription requests may be made via email, mail, fax or phone.

Please note that, by submitting material to *BVU*, you grant permission for BVR to republish your material in this newsletter and in all media of expression now known or later developed.

In the context of business valuation, the term "value" can have multiple definitions. So, before the onset of any valuation assignment, a valuation professional must specify an appropriate "standard of value." Common standards of value include *fair market value*, *fair value,* and *investment value*. However, for simplicity, this article assumes fair market value will be the appropriate standard of value for our discussion about value. As a reminder, fair market value is commonly defined as:

> The cash equivalent amount at which property would change hands between a willing seller and willing buyer when neither party is under any compulsion to sell or buy and when both parties have reasonable knowledge of the relevant facts.

Furthering the Warren Buffett philosophy, value is arguably what a buyer expects to receive from the purchase of a business, which is primarily a function of risk-adjusted returns, including dividends, earnings, cash flows, and growth thereof.

So, now that we have placed some context on the terms "price" and "value," we can now explore potential reasons for the divergence of price and value in marketplace transactions.

Deal Price vs. Fair Market Value of an M&A Transaction

When valuation professionals are called on to derive indications of value for a business or its securities, one of the common methods is to analyze the amounts paid to acquire companies that are comparable in nature to the subject company to be valued. Known as the M&A transaction method, an analyst will investigate the purchase price relative to a set of common earnings metrics such as revenue, EBIT, EBITDA, or certain operating metrics such as the number of subscribers for a cable-TV business or the number of available annual room nights for a hotel business. The transaction multiples derived from those earnings and/or operating metrics can then be extrapolated to derive indications of value for the subject company.

One might argue this valuation method is best used to derive an estimated purchase price for the subject company rather than deriving an indication of its fundamental value. A key element, which is often not considered when using the M&A transaction method, is knowing the buyer's motivation for entering into the underlying transaction being analyzed. We've all heard the phrase "beauty is in the eye of the beholder." However, when it comes to a business, the same can be said about its value.

Business buyers can have many different motivations for purchasing another company, and those motivations may be specifically unique to that particular buyer. Common motivations may include, but are not limited to, the following:

- Financial synergies that can be achieved through the combination of two independent companies or more. Such synergies may include costs savings through the elimination of duplicate cost structures, revenue enhancements through the combination of sales and distribution channels, and better utilization of research and development projects.

- It is cheaper to grow the buyer's business or enter new markets through an acquisition rather than making the financial investments necessary to create organic growth.

- A defensive move by the buyer to fend off competition or preserve market share.

- Management's self-interest to grow the business at any cost.

All of the aforementioned reasons can lead a specific buyer to purchase a business at a price much higher than the value other buyers would place on the acquired business. In other words, value was in the eye of the beholder. But the value the particular buyer perceived was not the representative view of most potential buyers.

The same rationale can also be used to explain the extraordinary price fluctuations in GameStop. Although some observers believed the fundamental value of GameStop ranged somewhere between $20 and $30 per share, the actual trading price was far greater due to the confluence of competing motivations the buyers and sellers engaged in the GameStop feeding frenzy exhibited. Some GameStop buyers were simply motivated by the prospects of short-term profits, while other buyers were essentially forced to buy shares to close out short sale positions that were going to expire. Needless to say, the trading of GameStop shares violated a fundamental element of fair market value: Neither the buyers or sellers are compelled to buy or sell. However, GameStop's short sellers were compelled to buy shares at any price to cover their open positions.

Early-Stage Companies

Early-stage companies also present a particular valuation challenge. From a fundamental point of view, a company's value should reflect the present value of its expected future cash flows. However, early-stage investors generally make their investment decisions based on an expectation the company will go through a liquidity event, either in the form of a sale or IPO, after a certain duration of time.

The expected liquidity event represents the investor's expected payoff, or total return of investment. More times than not, the liquidity event, or exit price, is estimated on optimistic expectations of an obscure metric such as projected customer encounters, hits on a website, or a forward-looking revenue multiple. However, the underlying value of the business when based on sound revenue and earnings projections can derive a far different amount than an investor's purchase price.

Among the explanations given for an expected exit price, projected synergies are often near the top of the list. However, synergies often prove to be more elusive than initially assumed. Accordingly, a valuation professional should account for the risk of achieving projected synergies by adjusting the projected cash flows, the discount rate, or the selected multiple.

As an example, using the fairness opinion for a tech industry acquisition that we recently reviewed, the fairness opinion provider calculated the exit value as a multiple of forward revenue. However, two elements of this analysis suggest this metric represents a price rather than a value. First, the use of a revenue multiple, rather than an earnings or cash flow multiple, implied the company was not expected to reach a normalized level of profitability by the end of the multiyear projection period. Second, a forward-looking revenue multiple for an early-stage company often incorporates overly optimistic growth expectations for the subject company than for the underlying benchmark companies. Accordingly, this suggests the terminal value might represent a price the company can be sold for rather than a fundamental calculation of its value.

Litigation Disputes—Computing an Award Amount?

When the aggrieved party in a litigation dispute seeks an award in the form of lost business value, the proper measure of redress is the amount that would place the harmed party in the same position he or she would have been absent the perpetrator's alleged bad act. To determine this financial award as a measure of damages, two threshold questions must be considered:

1. What would have the aggrieved party received absent the alleged behavior?

2. Would the aggrieved party receive the value of an asset, or the price of the asset?

This difference can manifest itself several ways. Take the case of a shareholder dispute involving an early-stage company. The transaction price of an early-stage company might reflect considerations other than those generally used in a fundamental valuation analysis. If the company would have sold for an exit multiple that can't be justified from a valuation perspective, then fairness may dictate the aggrieved party receive an award or settlement commensurate with the price paid rather than the value received.

On the other hand, some disputes require estimating the value of the company, which might be different than a contemporaneous transaction price. For example, in a solvency analysis, the standard of value is often present fair salable value, which practitioners generally consider equivalent to fair market value. In this case, a proper estimate of value might be more relevant than a contemporaneous transaction price that doesn't represent value.

The Final Word

Valuation professionals and academics have spent years trying to resolve the occasional chasm between an asset's price and its value. Ultimately, the differences can come down to measurements arrived at by different means and perceptions.

Prices can be determined by certain quantitative means such as market trend lines, trading strategies, and technical analyses, along with other more subjective elements such as emotions, confidence levels (or lack thereof), and greed. Value, on the other hand, tends to be based on certain fundamental objective measurements such as projected revenue, earnings, cash flows, and growth.

The real estate collapse that led to the Great Recession perfectly demonstrated this principle. For example, many houses that had a particular value derived from the use of fundamental appraisal methods ultimately sold for substantially less money because that was the maximum amount buyers were willing to pay.

Price is what one pays, and value is in the eye of the beholder.

Craig A. Jacobson *is a managing director at B. Riley Advisory Services in the firm's New York City office. He can be reached at cjacobson@brileyfin.com.* ***Richard B. Peil*** *is a senior managing director at B. Riley Advisory Services in the firm's Phoenix office. He can be reached at rpeil@brileyfin.com.*