Barber Analytics

# Valuation Issues in Gift & Estate Tax – June 2015

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## The *Estate of Giustina* and its Impact on Winery Valuations

In this issue I'll review the *Estate of Giustina* decision that provides support for the use of going-concern, earnings-based methods, and the exclusion of asset value methods, when valuing non-controlling interests. In addition, I will introduce market evidence that shows that minority winery investors are almost completely focused on earnings and cash flow, and have little regard, or use, for asset values.

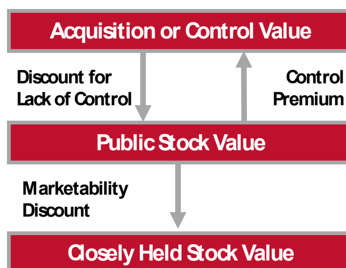
***Minority equity investors are almost completely focused on earnings and cash flow, and have little regard or use for asset values.***

### *Estate of Giustina* – The Tax Court and Ninth Circuit Decisions

Judge Morrison of the US Tax Court filed the initial opinion for the *Estate of Giustina* in June of 2011. The case involves the valuation of a 41.128% limited partnership interest in a partnership that owns 47,939 acres of timberland in Oregon. The partnership had been in existence since 1990, but was created from assets distributed from related entities that traced their roots back to 1917. The partnership's operation were quite simple - it grew, managed and sold timber.

The primary issue in the case was the value of the 41.128% interest. The IRS believed the interest was worth $33.5 million, while the estate filed a valuation of about $13.0 million. The difference of opinion arose due to the application and the weighting of different valuation methods. In short, the IRS expert weighted the asset method heavily (60%), while the estate's expert gave the asset method no weight at all. The asset method involves summing the value of the entity's assets in an orderly sale, subtracting the value of the liabilities, and arriving at the value of the equity (sometimes also called net asset value or NAV). This method is used primarily in the valuation of controlling interests because minority shareholders do not have the ability to cause the sale of the assets. Because this method results in a control "level of value" it usually requires the valuation expert to apply two discounts, a discount for lack of control (DLOC) and discount for lack of marketability (DLOM), when valuing a minority interest in a private company (see Levels of Value diagram to the left).

**Levels of Value**




Judge Morrison determined the value of the interest using his own methodology that differed significantly from the valuation experts' analysis. He determined that there was a 25% probability that a buyer of the interest would be able to create of voting block of 66.7% and force the liquidation of the partnership. In doing so, the buyer would have access to the partnership's $150.7 million in net asset value (versus the Court's going-concern value of $51.7 million before discounts). In addition, the Court did not apply any discounts to the asset value method because Judge Morrison believed the lack of control and marketability considerations were captured

in the probability weighting. The Tax Court concluded a value of $27.5 million for the interest.

The Ninth Circuit Court overturned the Tax Court decision saying the 25% weighting of the asset method was a clear error and “contrary to the evidence.” Judges Goodwin, Fletcher and Block explained a dissolution was not likely because i) the general partners would need to admit the new limited partner (the hypothetical buyer) that would then attempt to form a 66.7% voting block to dissolve the partnership, despite the fact that the general partners desired to continue operating the partnership, ii) none of the other limited partners had ever asked or discussed a sale of an interest. Given these facts, the Ninth Circuit found the Tax Court engaged in “imaginary scenarios” and “what combinations the purchaser might be able to effect.” Such scenarios, it seems, must be “reasonably probable,” not just “within the realm of possibility.”

***…100% of the industry-expert valuations investigated used earnings-based approaches, with one also including a sales approach. None used an asset method.***

The *Estate of Giustina* is an important decision for winery owners because they also often hold valuable, low-income-earning assets (vineyards). If the facts don’t support the reasonable probability of a sale of the entity or liquidation of its assets, The *Estate of Giustina* would lead us to ignore the asset method.

**Winery Valuation and the Asset Method**

Despite what the Tax Court and Courts of Appeal opinions say, however, they are not economic evidence. The more important fact is how minority investors actually do value minority interests, and for our purposes, how they value minority interests in wineries. Some winery valuation reports I have reviewed over the years have used the asset method to value minority equity interests when earnings are negative, or when the asset method value exceeds the value determined using earnings-based valuation methods. For wineries that source their grape needs from their own vineyards, this is usually the case. But most appraisers don’t appreciate that these “vineyard-heavy” wineries require special consideration. My research shows that earnings-based approaches provide the best indication of value

*“Haven’t you ever seen California wine being made before?”*

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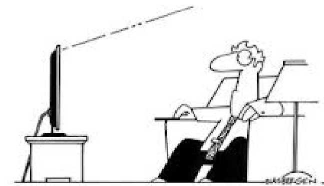
for minority equity interests in these vineyard-heavy wineries. And if it could be applied reliably, the asset method will reach a similar conclusion.

As discussed earlier, the asset method results in a control level of value, so to apply it to a minority equity interest in a private winery requires the application of two discounts: a discount for lack of control and a discount for lack of marketability. As I will show later, it is the determination of the DLOC that is so difficult to determine in the case of a winery that owns their own vineyards. Other going-concern valuation methods include the guideline public company method (GPCM) and the discounted cash flow method (DCFM). The DCFM focuses on future cash flows, while the GPCM can focus on any company measure (such as earnings per share or EPS, or revenues) relative to value.

***…the vineyard value alone (excluding the land, equipment and contract values) was far above the value the stock market was placing on the company.***

**How Do Minority Equity Investors Value Wineries?**
Whether a given valuation method is appropriate or not is often the subject of disagreement between private company valuation experts. I think this results from a lack of exposure to the public investing market. I come from a background in public investing, so am always a bit perplexed by this disagreement. If one wants to see the valuation methods used by minority investors, the best place to start is by reviewing brokerage firm research reports. These reports are written by analysts with deep expertise in the industry and its valuation methods. The reports usually develop a "target price" for the company, and detail the analyst's valuation method and assumptions. Valuation methods do vary across industries, and over an industry's lifespan. I think a very strong argument can be made that if a private-company valuation expert uses a method which isn't commonly used by industry expert analysts, they aren't really developing a value consistent with an informed buyer and seller. Without an informed buyer and seller, the valuation isn't consistent with fair market value. To answer the initial and obvious question of how minority equity investors value wineries, I researched the analyst reports of several US publicly-traded wineries.



"Stocks rose sharply today on news that this sort of thing still happens once in a while."

In the past 15 years, I found ten US wineries that were publicly-traded. Only four of the ten are still traded on the stock market today. I looked for current and historical brokerage reports for each of the wineries from reputable brokerage firms such as Chase H&Q, Deutsche Bank, and JP Morgan. For each winery I tried to find three reports from different analysts and reviewed each report to determine the valuation methods used. Four of the wineries either had no research reports or did not describe a valuation method. Of the remaining six wineries, I was able to find a total of twelve research reports. Of those, eleven used the GPCM and one used a DCFM. Of analysts using the GPCM, ten used a measure of future earnings to develop their target price, and one used a combination of sales and future earnings. I suspect this analyst included a sales measure because the winery was operating at a loss. In total then, 100% of the industry-expert valuations investigated used earnings-based, going-concern approaches, with one also including a sales approach. None used the asset method.

***…vineyard-heavy wineries are not valued using the asset method by minority investors.***

In performing this analysis however, it became clear that most public wineries source the majority of their grapes needs from third parties, or were "vineyard-light." Only one of the wineries with brokerage research

"Is it better to invest during a bull market or bear market? Depends...would you rather be gored or mauled?"

sourced all their grape needs from their own vineyards. And for that winery, the analyst made a crude attempt to calculate the value of the company's vineyards. He noted the vineyard value alone (excluding the land, equipment and contract values) was far above the value the stock market was placing on the company. In short, the public minority investors who set the stock price did not seem to appreciate the value of the assets. In the end, this analyst used an earnings-based approach to value the winery. In another report the analyst praised a vineyard-light winery for not investing in "low-returning assets such as vineyard land." In this winery, only about 1% of its grape needs were satisfied by grapes from its own vineyards.

Upon completing the brokerage report analysis, it was clear that for wineries that purchased most of their grape needs, earnings-based approaches were preferred by industry experts. And the same conclusion was indicated for wineries supplying most of their own grape needs, but only one brokerage report supported that conclusion. To buttress that conclusion, I turned to a different analysis.

*In none of the 30 10-Ks reviewed in detail did I find one that reported NAV, including the two vineyard-heavy wineries.*

Fortunately, there was one additional publicly-traded, vineyard-heavy winery in the study (that didn't have research). I postulated that if the stock market (and minority investors) valued vineyard-heavy wineries differently, I should be able to see evidence of this in their valuations relative to the vineyard-light wineries. Put more precisely, if vineyard-heavy winery NAVs were greater than their earnings-based values, and minority investors calculated and weighted the asset method in their determination of value, their equity values relative to earnings and revenues should be higher than the vineyard-light wineries.

**Are Vineyard-Heavy Wineries Valued Higher?**

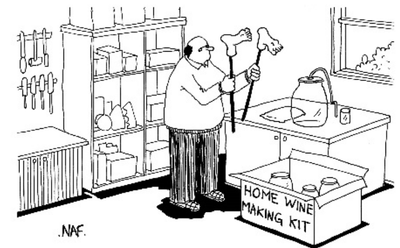
To begin this investigation, I looked more closely at the features of both publicly-traded, vineyard-heavy wineries. One winery supplied 82% of their needs from internal grapes, and the other 100%. One of these wineries was acquired, while the other, though still traded, does not file financial statements with the SEC any longer. I went back in time and looked at how minority investors valued these wineries relative to their peers based on measures of earnings per share, earnings before interest, taxes,

depreciation and amortization (EBITDA), and revenues over a period of 6 quarters before the winery was acquired, or stopped reporting.

The first winery, which sourced 82% of its grapes internally, was valued at a median EPS multiple of 7.9x over that period, while the similar vineyard-light wineries were valued at 13.9x. A 43% discount! Not the premium you would expect to see if minority investors weighted the asset method. The guideline companies only sourced about 20% of their grapes internally. I saw a similar pattern in the EBITDA and sales multiple valuations, which revealed discounts of 37% and 11%, respectively, for the vineyard-heavy winery. The second winery, which sourced 100% of its grapes internally (and sold substantially all its grapes under contract) traded at a median EPS multiple of 6.1x while the vineyard-light wineries traded at 19.4x. A 68% discount! Similar patterns were seen again in the other multiples. This comparison provides further evidence that vineyard-heavy wineries are not valued using the asset method by minority investors. If they were, they would have been valued at a premium to the vineyard-light wineries. In fact, the data shows they seem to be valued at a discount. This is likely attributable to the slow growth of the vineyard-heavy wineries due to the very expensive cost to expand earnings under an "own-all-your-vineyards" strategy. Vineyard-light wineries, by contrast, have much more flexibility to grow by simply expanding grape supply contracts.

***Based upon my analysis, the equity of the company traded at a 69.6% discount from its NAV.***

But let's consider that, despite the evidence, the valuation expert attempts to apply an asset method. Is it possible to reliably apply the i) asset method and ii) DLOC? The answer to the first question is yes. Analysts, with cooperation and information from the winery, can have the asset values determined. Assets would include land, vineyards, winery buildings and winemaking equipment, farming equipment, inventory, brands or label values, and perhaps goodwill. The answer to the second question is maybe for the vineyard-light winery, and no for the vineyard-heavy winery. The limited data available makes the application of the DLOC for vineyard-heavy wineries unreliable. But, let's look at the data there is.




**If the Asset Method is Applied, What DLOC Data is Observable?**
Recall from our earlier discussion that the asset method results in a control level of value, and it must be discounted to reach the publicly-traded value. In order to apply the DLOC we need to observe it from similar companies trading on the public markets, or we may be able to observe the discount in acquisitions of whole companies. Care must be taken though to find acquisitions of companies that have a similar level of vineyard ownership, as the DLOC does appear to be impacted by this characteristic. For vineyard-heavy wineries, we must look to both NAV discounts of public companies and acquisitions because data on their DLOC is very difficult to find.

***…the value estimate reached using the asset approach and a DLOC is consistent with using earnings-based approaches only.***

In my experience, the only publicly-traded companies that regularly report NAV are closed-end investment companies. They generally hold publicly-traded securities, so net asset value is relatively easy to determine. To verify that net asset values aren't reported for wineries though, we examined the 10-Ks for each of the ten wineries we studied earlier for the 3 most recent years available. In none of the 30 10-Ks reviewed in detail did I find one that reported NAV, including the two vineyard-heavy wineries. In order to develop a NAV then (and ultimately determine the DLOC), the analyst must value the assets of the public winery. This is an inherently imprecise task due to i) the lack of detail provided in SEC filings, and ii) the lack of access to winery management to ensure a reliable identification and valuation of the assets.

"After federal, state, and local taxes, you get one-third of a wish."

As I mentioned previously, one of the two public wineries which grew most of their own grapes was ultimately purchased, and this made looking at the acquisition price the most efficient way to calculate a DLOC. The other winery remained publicly-traded and, fortunately, had fairly simple operations and provided some information on its vineyard holdings to make it possible to make an estimate of NAV. I focused on this winery first.

*These two examples provide evidence that the stock market, and minority investors, heavily discount asset-heavy agricultural entities from their net asset value.*

This winery was a California wine grape grower that had a very small winery operation. I sought the opinion of a vineyard appraiser who was familiar with their holdings, and made a conservative estimate of the value of their grape sale contracts. As the company is no longer making SEC filings, I had to go back several years to determine the NAV discount. Based upon my analysis, the equity of the company traded at a 69.6% discount from its NAV. This is the same winery that had a brokerage report which noted its net asset value was above the stock market value.

To seek further evidence of DLOCs within the agricultural industry, I also expanded the NAV analysis to include other public crop-growing companies. I found a second company that was in the nut industry. They sold 100% of the nuts they produced and had no other material operations. Nuts are similar to wine grapes in that they produce a crop once a year, yields are variable, and they can be enhanced and used in other products. I was able to estimate the value of the nut orchards by reference to other sales around the time of the analysis. Based upon my estimates, the nut producer traded at a 66.1% discount from NAV. These two examples provide evidence that the stock market, and minority investors, heavily discount asset-heavy agricultural entities from their net asset value. This is likely the result of valuing companies based upon their current and forecast earnings.

As discussed above, one of the two vineyard-heavy US wineries was purchased. This is helpful as an alternative to developing NAV discounts from public companies. After all, the DLOC is just the mirror image of the control premium paid for a public winery. The key in applying this methodology correctly is to find a comparable transaction. Several characteristics need to be considered, such as the level of profitability, but the level of asset ownership is key. The winery was purchased at a very high

control premium of 133.3%, implying a DLOC of 57.1%. This transaction also supports the estimates above that vineyard-heavy wineries are valued at very high discounts to NAV.

Based upon this transaction and the two NAV discounts estimated above, and my experience valuing vineyard-heavy wineries using both earnings and asset-based methods, the value estimate reached using the asset method and a DLOC, is consistent with using an earnings-based approach only.

**Conclusion**

Having researched how industry experts value wineries, investigated whether vineyard-heavy wineries are valued at a premium to other wineries, culled the available data for the DLOCs for vineyard-heavy wineries, there is a no evidence to support the use of the asset method to value minority interests in going-concern wineries, or that, based upon the information that is available, it would result in a different conclusion than earnings-based approaches.

The *Estate of Giustina* US Court of Appeals decision supports this evidence with the caveat that if the facts support that a sale of the entire company, or a liquidation of assets, is reasonably probable, then the asset method should be considered and weighted in the value conclusion.

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