Closely-Held Business Owners: Do Your Estate Planning Now
by J.L. Pierson, ASA

The sadly reduced values of traded equity securities have affected the value of closely-held businesses. The latter are also down, but few statistics are available at this point. This article argues that this is the right time to do the estate planning you need to do at the lower fair market value.

The Dow now stands approx. 40% lower than at its last peak over a year ago. A credit crunch is in evidence, as legitimate corporate financing needs are not being met. Homeowners who overextended themselves are still overextended, as house prices have dropped. A recession has been called.

The reason for the decreasing values of closely-held businesses is empirically easy to grasp as it now takes longer to sell a business. Certainly the economic outlook is not good for many business sectors. But there are other reasons, and some are due to changes in the theory and practice of business valuation, as illustrated below.

An income approach to valuation uses the discount rate as the mechanism which translates business profits into values. Discounts have traditionally been calculated as the sum of (a) the "risk-free" rate, a proxy for the long term return of government bonds, and (b) the Equity Risk Premium ["ERP"] which measures, over long periods of time, the return of owning equities as opposed to government bonds, (c) a size premium, on the theory that smaller companies are riskier than larger ones, (d) an industry risk premium measuring the relative risks of the industry and (e) a specific premium addressing all other business risks. The ERP is often adjusted by a Beta factor, designed to measure the relative volatility of one security compared to the market as whole.

Until approximately ten years ago, there was only one source of ERP and associated data. Ibbotson Associates has published its ERP annually since 1976. For the period ended Dec. 31, 2007 it stood at 7.2%. Over the years, however, academic researchers have established that the ERP should be in the 3.5% to 6% range, depending on where we are in the business cycle. In other words, discount rates based on Ibbotson data only are generally wrong. While Betas are part and parcel of the capital asset pricing model, used since the sixties and still valid, it is difficult to work with betas. There are several ways to calculate betas for public stocks but not for private ones.

Since 1996, a new methodology has been available which calculates the sum of items (b) through (e) above by resolving many of the Ibbotson shortcomings. The Duff & Phelps Equity Risk Premium Report - formerly published by S&P - provides annual regression formulas which easily develop a credible ERP for any business. They are based on an analysis of securities returns since 1963 and the last version, calculated based on data up to the end of 2007, uses a 1963-2007 average ERP of 5%.

The author of the Duff & Phelps Reports recently indicated that the turmoil in the equity markets has had the effect of raising the ERP to the top of its historical range. In other words, the ERP just went from 5% to 6%. By adding the extra 1% to the value returned by the 2007 regression formulas and the current long term U.S. treasury bond rate, a well supported discount rate is easily calculated. Everything else being equal, the adjustment produces a somewhat lower supportable value, but the increase is mitigated by lower treasury bond rates.

It should be noted that, unless other studies place the 3.5-6% historical ERP range into question, the above adjustment could be final until the economy improves. This also means that the chances of a higher ERP in the near future are almost nil, given that we are now at the top of the range. For that reason alone, the time for estate planning is indeed now.

What else has changed in the valuation of private businesses in these turbulent times ? Some analysts have suggested that, based on much higher market volatility, lack-of-marketability discounts - which appear to follow volatility, may have to be increased. There is, however, little consensus on the practice, which would also reduce values, because the link between restricted stocks discounts and private company discounts has not been conclusively made.

One Estate Planning technique in particular - the GRAT or Grantor Retained Annuity Trust - stands out as particularly appropriate at this juncture for the following reasons: the current tax exemption is now $3.5 million, will revert to less than $1 million next year unless Congress intervenes; a liberal Congress and President have been elected; the Section 7520 rate for January, 2009 [a return which the GRAT should exceed for the technique to be successful] is 2.4%, and values of both real estate, securities and closely-held businesses are relatively low, as indicated above. While the writer is not a lawyer, and can not authoritatively tell whether a GRAT is the best technique for you, a GRAT is worth investigating.

Estate Planning, anyone ?

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