DO STOCK MARKET PRICES REPRESENT FAIR MARKET VALUE?

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Recently, our firm, Corporate Valuation Services, which specializes in technology based enterprises, prepared a Valuation Report on a privately owned supplier to the Telecom industry. in any valuation, one essential is to find publicly traded guideline companies. As our client was of significant size, we first looked at the Value Line Investment Survey section on the Telecommunications Equipment Industry. Their coverage includes fourteen companies whose shares, on average, declined 30.5% in the third quarter of 1998, nearly 2.5 times the 12.4% loss sustained by the Dow Jones Industrial Average.

Six of the shares plunged by over 40%, led by Pairgain Technology, whose share price dropped by an astounding 53%. Did Fair Market Values change so much, so fast?

This intensified our detailed review of the stock market performance of these fourteen companies, of which eight trade on the New York Stock Exchange and six on NASDAQ. As of November 5, 1998, the range between their highs and lows for the year, as a percentage of the lows, exceeded 90% in every case, with one reaching 400%. The analysis set out individually in the attached schedules, shows the following dispersion of the changes:

Under 100%	1
100% to 150%	4
150% to 200%	5
200% to 250%	2
250% to 300%	0
300% to 350%	0
350% to 400%	2
	14

In drawing conclusions from guideline companies, most valuators follow the process described in a well-respected publication, "The Guide to Business Valuations"; the eighth edition of March, 1998, states:

> 620.03: In most cases, the consultant will use the comparative company's stock price per share as the numerator of a value multiple. The consultant may determine the price per share as of either of the following periods:

a. The date of the valuation, or the immediate prior Friday if the valuation date is a weekend.

b. An average of the comparative company's high and low price during the period immediately preceding the valuation date. The period used usually should not exceed one month.

Most consultants use the stock price as of the valuation date as the numerator of the value multiple computation. This stock price is usually available in the Wall Street Journal for the appropriate day. Some consultants argue, however, that day-to-market price fluctuations reflect psychological factors that are not relevant to a company's 'fair market value.' These consultants tend to prefer the average price approach discussed in item b) above. When the average price approach is used, the consultant should ordinarily not use a price that occurs after the valuation date.

Can the last 30 days be considered a suitable period? The October 9, 1998 issue of the Value Line Investment Survey covered this industry. Comparing their prices with today's levels, the changes for the fourteen companies during the four week period were almost random.

Negative	2
Under 10%	1
10% to 20%	3
20% to 30%	3
30% to 40%	3
40% to 50%	2
	14

Did the Fair Market Value of a company change by more than 40% in four weeks, or were both sets of prices "noise", with neither representing Fair Market Value?

Trying to reach a conclusion as to whether the October 9 or November 5 prices represented Fair Market Value, we expanded our analysis, as shown in the three attached schedules.

General Datacom and Loral Space had losses in 1997, which Value Line expects to continue. Outside of those two exceptions, projected growth in earnings per share from 1998 to 1999 was good, varying from -10% to 550%, but there seemed to be no relationship between these growth rates and the price/earnings ratios.

Few of the companies had significant debt. In only four of them, equity represented less than 80% of their enterprise value, and three of them had the worst four-week performance of the group.

Company Equity Change in Position Enterprise

Value	**%**	**%**
General Datacom	52.1	2.1
Allen Telecom	56.2	-3.2
Salient 3Com	63.0	-7.2
Loral Space	63.6	11.9

There was no other financial factor apparent that could have any significance, and could have caused this. Therefore, we reached the conclusion that there had been a major change in Investor Enthusiasm towards the industry. This is supported by the commentary of George Rho of Value Line, who stated:

> "Investors were willing to pay ridiculously high multiples for telecom earning only a few weeks ago, bidding as much as 65-time prospective twelve-month profits for behemoth Lucent. The pendulum has swung the other way now, with some issues, like ADC Telecommunications and Qualcomm, selling at huge discounts to their growth rates. Reversion to less emotional valuation levels will likely reward the intrepid investor in the coming months."

In periods, such as the present, when stock market volatility is high and group rotation rapid, suggesting major changes in Investor Enthusiasm for different industries, we believe that stock markets do not necessarily represent Fair Market Value, and the valuators must be extremely careful in drawing any conclusions from publicly traded shares of guideline companies.

In many cases, publicly traded shares have been heavily punished by institutional investors, resulting in declines of up to 30% in a day, for failing to meet analysts' earnings expectations, even if the shortfall is only $0.01 a share. Under such circumstances, the application of historical price/earnings ratios is extremely risky.

One solution is to establish price/projected earnings ratios, using forecasts from First Call, than to smooth the numbers for several months by means of a moving average.

Your client may question you about an overly cautious approach to high stock market prices, believing that his company is better than some public entity whose shares trade at an unexpected level, no matter what the industry. You have the choice of either arguing your position, or to present two scenarios and apply probabilities to each.