

Market Turmoil May Require New Ways to Build Up Cost of Capital

By Michael Goldman, MBA, CPA, CVA, CFE, CFF

Government is radically altering its role in the economy, in response to the lack of liquidity in the private sector. Massive government borrowing will likely absorb most of what is left of the country's investable funds in the near future. The federal government owns, or will soon own, major parts of the country's banking system, housing sector, automobile manufacturing sector, and other industries or companies that are considered strategically, economically, or socially important. More regulation in many sectors of the economy, and especially in the financial sector, is a virtual certainty. This will most likely muffle innovation and productivity, and hence both profitability and growth rates.

Remember Enron, how stunning that was at the time, and how it permanently changed the public accounting profession? Bernard Madoff, a former chairman of the Nasdaq Stock Market, has been accused of running a \$50 Billion Ponzi scheme that may have gone on for over 20 years, right under the nose of the SEC. Lately it seems that both insolvencies and frauds of Enron magnitude are being announced on a weekly basis, scaring investors so badly that they will not advance money to anyone other than Uncle Sam.

For decades our economy has relied on constantly increasing amounts of leverage. Now the economy is massively deleveraging, as creditors no longer trust in the solvency or integrity of borrowers. Lack of credit creates a vicious cycle of greater insolvency, which leads to even less credit availability. Trillions of dollars of

wealth stored in almost any class of asset you can think of has gone to "money heaven," in what appears to be a deflationary environment. Yet logic dictates that all of the money the government is shoveling out against this tide of de-leveraging is bound to eventually become strongly inflationary.

In October the entire country of Iceland, which until recently was considered by the *Economist* magazine to be one of the richest countries in the world, financially collapsed and essentially went bankrupt. Meanwhile CNN reports that the inflation rate of Zimbabwe, once one of the most prosperous countries in Africa, is now 11.2 million percent. That is not a typo. A loaf of bread that cost 200,000 Zimbabwe dollars in February now costs 1.6 trillion Zimbabwe dollars. Nobody expects financial conditions in the United States to get as extreme as Iceland or Zimbabwe, but the turmoil in today's capital markets does raise very serious concerns.

New Cost-of-capital Equations

In the late 1970s, the accounting profession was obsessed with "inflation accounting." FASB Statement 33, Financial Reporting and Changing Prices, was issued in September 1979 to meet "an urgent need for information about the effects of changing prices." *One of the unalterable bedrock principles of accounting, historic cost, was altered for the first time due to prevailing economic conditions.* The business valuation profession may be in a similar situation today. We need to determine whether our traditional measures

of cost of capital hold up in today's lack-of-liquidity environment. When the crisis passes, as it eventually will, will the way we calculate cost of capital remain the same, or will there be new factors built into our equations?

Massive government intervention distorts market efficiencies. Violently changing asset price levels, up or down, create gaps between historical averages and current market conditions. Currency fluctuations, international cash flows, trade protectionism, capital availability, demographics, and other factors in more stable times had such a small or unchanging impact on the cost of capital that it was acceptable to just consider them within the context of the larger market numbers that valuation analysts used. Until the markets return to a quieter dynamic, which may take years, some or all of these factors may need to be individually evaluated and added to cost of capital build-ups in order to more accurately calculate market values.

The Core of Business Valuation

If you were testifying today about your client's cost of capital, and knew you were going to undergo a ferocious cross-examination, what would your testimony be?

It seems to me that the cost of capital is the core of business valuation. It is the discount rate used to bring the expected future benefits of owning a business back to a present value, considering the cost of money, alternate investments that could be made with that money, and the risk components of the investment.

I typically value equity interests, and am often most comfortable with the income method of valuation using a built-up cost of capital. I like it because it is (a) forward looking, (b) theoretically sound, (c) well-accepted in the business and finance community, and (d) easier to justify in litigation matters than questionable comparable market transactions or a "sum-of-the-parts" asset approach that leads to challenges of each and every individual asset value.

I lost a significant portion of my net worth in the August 2007 stock market debacle and another, greater portion in what I un-fondly call the September and October 2008 crash. Many of my clients have fared much worse than I have because of IPOs that got cancelled, loans that got called, loan commitments that got cancelled, and businesses being foreclosed on. A client who had a personal net worth in excess of \$25 million two years ago is having his house foreclosed on this month. Another client with an 18-year solid banking relationship is suddenly having his loan called at the lowest point in his seasonality, for a minor covenant violation that would ordinarily be waived for a small fee.

As I write this, it seems like there is no capital available at any price. The government is throwing money at the banks, but banks certainly do not seem to be throwing that money at

their customers. Bankers seem aggressive on the calling-loans-in front, and timid on the extending-new-credit front. Equity investors have all but disappeared, either because they no longer have money to invest or they are waiting for even better bargains as the market continues downward. In the moments when I am not licking my own financial wounds or helping clients staunch their financial bleeding, I've wondered how I would testify about the cost of something (capital) that at the moment is scarcer than snow in the desert.

How Did We Get Here?

Anybody who does not believe that the economic crisis has dramatically changed our world should digest this quote from the *Los Angeles Tribune*, while asking themselves if they have ever seen the IRS embrace compassion and economic reality as an operating policy:

The Internal Revenue Service is easing rules to make it easier for homeowners facing liens for delinquent taxes to sell or refinance their houses. "We need to ensure that we balance our responsibility to enforce the law with the economic realities facing many American citizens today," said IRS Commissioner Doug Shulman.

The article goes on to say that the IRS is willing to subordinate its interests in favor of mortgage holders, which actually isn't that shocking once you realize that there is a better than 50 percent chance that the federal government is now also the mortgage holder.

There are many competing theories as to what has caused the current liquidity crisis, from not enough regulation to too much government, from ruthlessly greedy corporate managers to lazy or incompetent corporate management, from sophisticated criminal activity to misguided bumbling, from fraud against mortgage lenders to fraud by mortgage lenders. The answers so far seem to be more dependent on whose blog you read than on any scholarly analysis.

Up until 2008, the insolvency business was booming. My own anecdotal perspective is that for years there was too much money chasing too few real, viable opportunities. Both investors and banks were shoveling money as quickly as they could towards hedge funds and other financial investors, hoping to get their dollars in before someone else beat them to the punch. The hedge funds and financial investors were under pressure to do deals in an increasingly competitive environment where good companies to buy were getting scarce. Doing questionable deals, it seemed, was better than giving back the money they had raised.

I worked on a case a couple of years ago where a business owner received three bids for his company, ranging from \$32 million to \$35 million. At literally the day before the sale, an investor fund that had done very little due diligence swooped

in and paid \$52 million for this company. They proceeded to pile it up with debt, replace a successful management team with managers who had never worked in that industry, replace functioning technology with new systems that didn't work, and slash costs without first understanding what was important to the company's customers. Granted I only seem to get invited into deals that have gone bad, but this case seems to be fairly representative of what professionals in the insolvency arena have worked with for much of this decade.

In terms of the cost of capital, it was a buyer's market, and capital costs were steadily decreasing. More and more capital chasing fewer opportunities made abundant capital cheap.

In late 2007, insolvency business dried up. Banks stopped lending, stopped modifying non-conforming loans, and started talking at their customers instead of with them. In the past, banks typically funded the workouts and turnarounds of troubled customers. Now their mantra seemed to be "not another dime from us." Foreclosure, once considered an ugly thing to be avoided as much as possible, seemed to become fashionable as banks raced to grab whatever collateral they could, no matter what it cost them in the immediate loss of value that accompanies the transition from "going concern" to "distressed, immediate liquidation." Again, this is anecdotal, but a number of bankruptcy lawyers and insolvency professionals have complained about their lack of business because lenders would rather foreclose than fund turnarounds or orderly resolutions. There is no question that the availability of capital has gone down and the cost of capital has gone up.

Survey data are just beginning to back up the anecdotal impressions of insolvency professionals. A recent survey found on CFO.com noted:

The 115 CFOs and other top-level finance execs who responded said that since September, the quality of some services provided by their commercial lenders has deteri-

orated. A majority said it costs more to borrow; banks are less able to make lending decisions and commitments; and that banks are also less flexible. Surprisingly, 39 percent said that even the range of services and products available from their commercial lenders had narrowed. Moreover, many CFOs responding to the survey were pessimistic that the federal government's program to inject \$700 billion of capital into banks will improve things.

Another survey, also cited on CFO.com, notes:

About 95 percent of U.S. banks reported increasing the cost of credit lines to large and medium-sized firms, while 90 percent reported doing so for smaller firms, according to the October 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices.

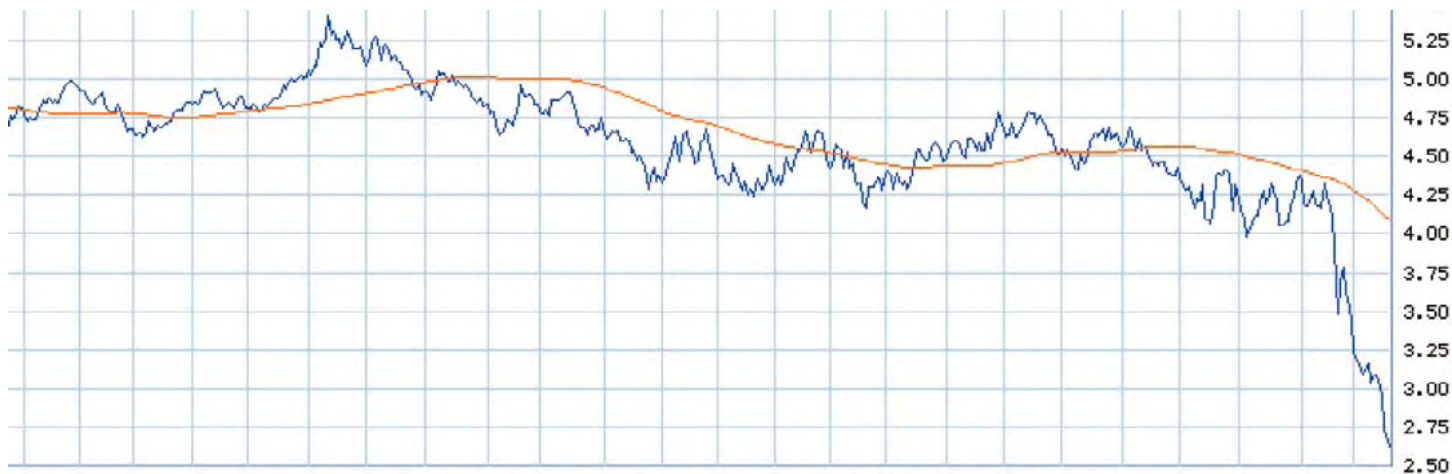
Suddenly, in late September 2008, the insolvency business exploded. Again, no hard verifiable statistics, but everyone I talk to says their phones are ringing off the hook. The reason is not that lenders have decided to fund workouts again, the reason is that there is no capital to be found, anywhere, at any cost, for a large number of troubled businesses that need to come to some kind of resolution.

Cost of Capital Calculation

Cost of capital is usually defined as *the expected rate of return that the market participants require in order to attract funds to a particular investment*. To fully understand this definition, it is useful to take it apart piece by piece:

- The *expected rate of return* reflects investor expectations. It is forward-looking, as opposed to historical.
- *Particular investment* is specific to the company being analyzed—the cost of capital depends on the riskiness of the specific situation, not the market as a whole and not in terms of any particular investor.

Figure 1: Yield on 30-Year U.S. Treasury Bills, Two Years Ending December 2008



- The cost of capital is *market-driven*. It is determined by the returns available in the market on alternative investments.
- *Attract funds* implies that the price of those funds is sufficient to encourage investment.

The typical build-up method of calculating the cost of equity capital consists of the risk-free rate plus a risk premium. The risk premium has separate components for general equity risk, company-size and/or industry risk, and company-specific risk.

“Risk-free” Rate

The risk-free rate is typically derived from the yields on long-term U.S. government bonds on the valuation date. As of mid-December 2008, a chart showing the yield of the 30-year U.S. Treasury over the past two years looks like Figure 1 (page 25).

This does not look very “risk-free” to me. This looks like a government and/or an economy in crisis. This looks like the market is pricing in very low inflation at a time when world governments are pumping more money and liquidity (which typically fuel inflation) than has ever been pumped in the history of the world. This looks like the market is saying the U.S. government has very little default or maturity risk when many economists and investors are saying that the seemingly non-stop printing of more money is seriously debasing the U.S. dollar as a store of value.

In actuality, a very low “risk-free” rate says that the market sees risk everywhere as being so high that it will accept guaranteed negative real returns in exchange for perceived safety. The December 9 auction of U.S. Treasury bills was described by the *Financial Times* as follows:

Nervous investors on Tuesday paid for the privilege of owning U.S. government debt, pushing interest rates

on three-month Treasury bills to negative levels for the first time in postwar history. The implied yield for three-month bills briefly traded at negative 0.01 per cent—the first time that has happened since 1940, traders said. At such a level, an investor is essentially paying someone to own the security.

Investors are not saying that the risk-free rate is close to zero, they are saying that there is too much risk, at any cost, for them to put their money anywhere other than dollars. They would rather lose a little bit guaranteed, than lose more in any other investment. Valuers need to seriously contemplate what this low a “risk-free” rate implies, and realize that it actually means much higher costs of capital, not the lower costs you would derive by just plugging it into a standard historical model.

Equity Risk Premium

The equity risk premium, which is often based on historical data, represents the higher returns that investors demand for assuming the higher risk of owning equity rather than debt. The risk is often manifested in the higher volatility seen in stock market returns. Historical information used for this risk premium typically comes from the *SBBI Yearbook* or from the risk premium reports published by Duff & Phelps.

Once again, a picture speaks a thousand words. Figure 2 shows the S&P 500 Index over the past year.

This picture says to me, again, that capital is definitely getting more volatile and more expensive. As long as investors face the prospect of further stock market losses, margin calls, fund redemptions, and headlines filled with tales of fraud and bankruptcy, capital for equity investment will be scarce and risk premiums will be astronomical. The published historical data is not keeping up with the rapidity of the market changes.

Figure 2: S&P 500 Index, 2008



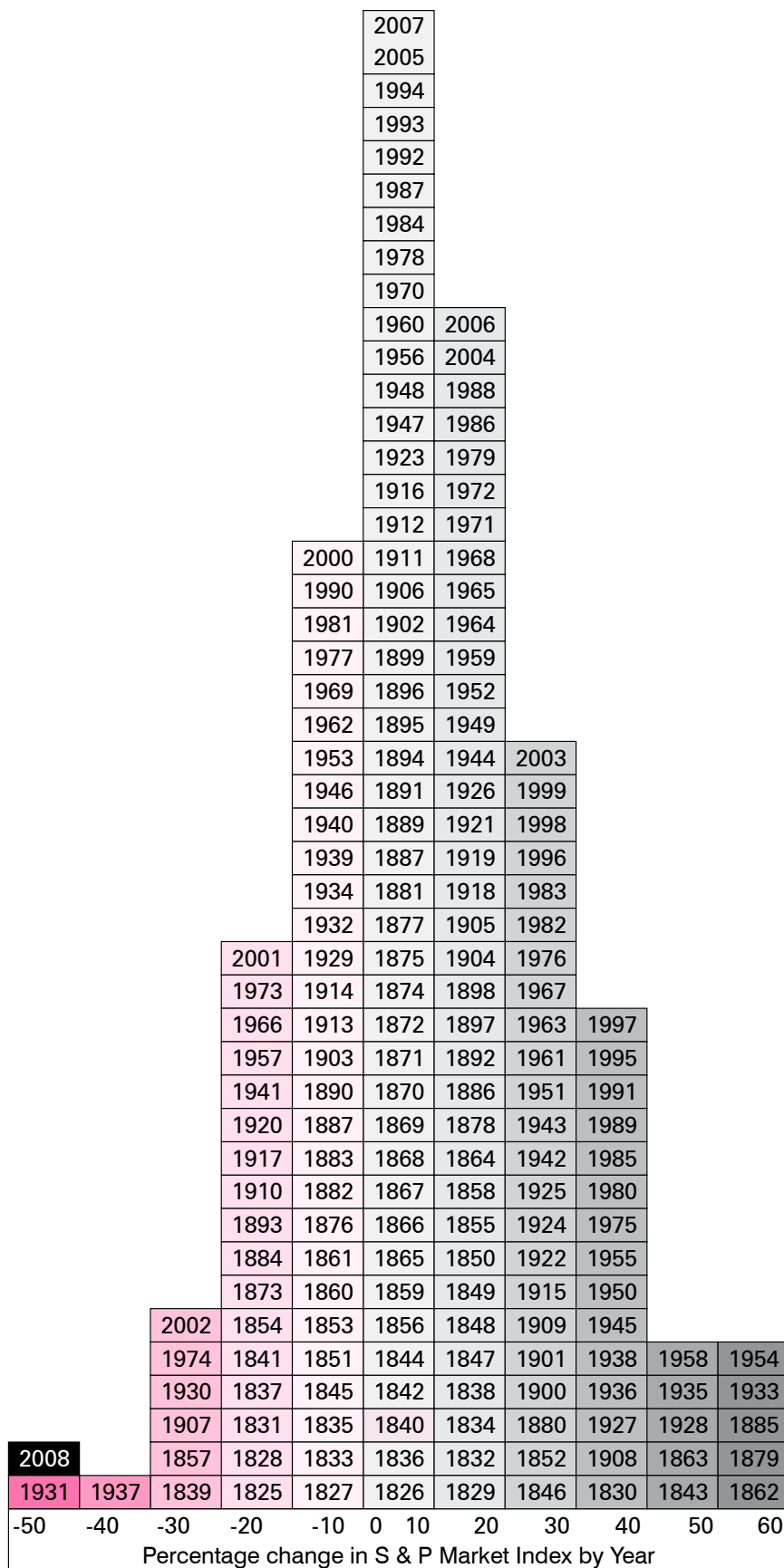
Stock market returns in 2008 were at the far end of the tail. The only other years in U.S. history that were this extremely bad were 1931 and 1937 (see Figure 3).

It seems like 2008 was the correction and reversal of a long period of accumulated excesses, or the signaling of a new paradigm in the economy. If so, valuers will need to question their usage of historical averages and might have to find some other basis with which to evaluate forward-looking rates of return. Equity risk premiums are going to need more attention and validation than they now receive in most valuation reports.

Small-company and Industry Premiums

Duff & Phelps combine the equity and size premiums in their report, while the *SBBI Yearbook* calculates separate premiums for size and industry. The consensus in the valuation profession seems to have been shifting away from SBBI and towards Duff & Phelps in the past couple of years. I've used both in my recent valuations and have arrived at similar costs of capital from the two sources. I have a feeling, though, that that may be changing—liquidity and politics may become bigger determinants of risk premiums than the historical market data currently used by valuers. In 2008 the U.S. economy became highly political, with the government deciding which industries and companies should be saved and which could fail. Heavy construction companies, for example, are highly distressed and liquidating at very low values. I can see this changing overnight once the new administration starts spraying hundreds of billions of dollars across the land in make-work infrastructure projects based more on job creation than on economic fundamentals. Two companies with identical financial statements could differ greatly in value if only one of them is in a government-favored industry or location.

Figure 3: Percentage Change in S&P Market Index by Year



The current carnage in the market is widespread but is also hitting some industries much harder than others. For some industries, SBBI data may pick this up more accurately than Duff & Phelps. For example, the SBBI risk premia for SIC Code 616, Mortgage Bankers and Brokers, was -5.32 percent in the 2004 Yearbook, -2.34 percent in the 2007 Yearbook, and +10.825 percent in the 2008 Yearbook. For a mortgage broker, the industry they are in is probably a greater determinant of their risk profile than which size tranches they fall into.

It is no longer intuitively clear to me that the market will consider size as a key determinant of risk this year. In a year dominated by news of Bear Stearns, Countrywide, Lehman Brothers, Merrill Lynch, Washington Mutual, Wachovia, Citibank, General Motors, Indy Mac, etc., it is difficult to argue that bigger is always safer. I'd present more stock graphs to demonstrate this point, but they could cause extreme nausea in former investors in these once blue-chip companies. Meanwhile, both SBBI and Duff & Phelps could be overstating the importance of size by using historical data rather than the current situation.

At the beginning of the dot-com crash, I prepared a valuation of a high-tech company in the telecom market, and was surprised to find that none of the traditional value drivers showed a strong relationship to the market caps of companies in the industry. After regressing nine different variables against the market caps for 72 different companies, I found that the only variables having a decent correlation to value were working capital and debt-to-equity ratios. Even the size of the company didn't matter—recent startups flush with IPO cash and minimal sales were selling at much stronger valuation ratios than industry giants such as Lucent, Nortel, Ericsson, and Solectron. The market was stating at that time that liquidity was more valuable than technology, management, markets served, or other variables typically associated with the valuation of high-tech companies. The same concept is evident today in the stocks of many companies, whose share prices reflect their liquidity and burn rates more than their growth and profitability prospects.

The Duff & Phelps D-exhibits show the impact on perceived risk as operating margins change. The valuator in me thinks these tables could become more important as the markets shift from a focus on opportunity to a focus on sustainable profitability. My insolvency side, though, suspects that liquidity and financial sustainability (cash on hand vs. burn rate) may explain more of a company's market cap than "just" profitability does. My cynical side (I am from Illinois, the pay-to-play state) worries that political factors will become more of a component of value in an increasingly government-dominated economy. It will be interesting to see which data tables, if any, can accurately capture the dynamics driving value in today's markets.

What is becoming clear is that the days of simply grabbing numbers off of published tables to calculate a risk premium are over. The question isn't whether Duff & Phelps or SBBI is the better data source, the question is which one is most appropriate to the specific situation being valued, and what other factors also need to be considered. Whether it is size, liquidity, industry, operating margins, or other economic factors discussed above that have not traditionally been separately broken out in build-up models, it is critical that the valuation analyst figure out what most accurately reflects the risk profile of the specific company being valued and find the appropriate data for each identified driver of risk.

Specific-company Risk

Specific-company risk accounts for characteristics of the subject company that give it a greater or lesser risk profile than the typical company in the size range or industry to which it is being compared. In the past I focused mostly on management, operations, and the company's ability to execute its business plan in its market and against its competitors. Clearly, financial strength and the probability of staying alive long enough to get through the current lack of financing availability (refinancing risk) will now need much greater scrutiny in this environment and are likely to become common elements in the cost of capital calculation. The needier a company is for capital, the more that capital now costs, regardless of the company's size or industry.

Political factors may also need to be built into risk premiums. For example, a small parts supplier selling to the automotive industry could have had its risk profile changed dramatically after the government bail-outs of both GM and GMAC. Ford, which was much more solvent than GM in November, is now competing against a government-subsidized entity. Foreign car makers, which are in better financial and market shape than the domestics, may now be up against a ferocious buy-American campaign as unemployment concerns trump environmental concerns for the first time in decades. The risk profile of the parts supplier's customer mix may have totally inverted in just one month's time.

Other Factors

The SEC has already jumped on the solvency bandwagon. Marc Panucci, an SEC associate chief accountant, told an AICPA conference recently that:

In today's economic environment, changes to existing disclosures or incremental disclosures may be necessary to comply with the disclosure requirements in areas such as risks and uncertainties, liquidity, and credit risks, just to name a few.

The SEC wants to see much more discussion of com-

pany liquidity to help investors gauge a company's prospects for the future and even the likelihood of its survival. These data could lead to new data tables from one of the data sellers, and if credit stays tight enough for long enough, then refinancing risk will likely become another line in the standard build-up model.

All of the major investment banks that provided much of the capital for the last few decades are suddenly gone. Banks and insurance companies no longer provide the liquidity that they recently did. Pension and endowment funds, another

huge source of investment money, could themselves be insolvent after both their recent diversifications into less liquid asset classes and the huge market drops of 2007 and 2008. California, Michigan, Ohio, Phoenix, Atlanta, and Philadelphia are just the first in what promises to be a long line of governmental units approaching insolvency. As state and local governments start competing harder for ever-scarcer capital, the availability of capital may become such an important factor that it needs to be measured and built into cost of capital calculations as of given points in time.

Bankruptcy: the Bleeding Edge?

Until now, bankruptcy practice has not contributed to valuation theory as much as tax and family law have. That is about to change.

Will the recent market crash and widespread fear and pessimism become just a historical footnote, like the market crash of 1987, or will it be a generation-defining event like the Great Depression or Pearl Harbor was? Will government policies (new lending policies, new regulations, new security laws, nationalization of some industries, new tax regimes, abrogation of contracts, etc.) factor into cost of capital calculations?

I don't know the answer to those questions, but I suspect that one of the first places we will see the answers is in bankruptcy court decisions. Until now, bankruptcy practice has not contributed substantially to valuation theory. Based on the amount of professional literature published, it certainly looks like tax and family law contribute much more to the valuation profession than does bankruptcy. Tax cases can take many years to work their way through the system, however, and divorce practice varies enough from state to state that initial groundbreaking decisions may not be immediately expected to have national implications. Bankruptcy today has the sense of urgency to get it into court immediately and to resolve issues faster. It is possible that bankruptcy court will become the leading edge in valuation-related court decisions.

The financial world is changing by the day. Shortly before this article was written the laid-off employees of Republic Windows and Doors in Chicago staged a five-day protest and had the President-elect, the Illinois governor, the Chicago mayor, a high-ranking United States senator, and major labor unions all strong-arm Bank of America

(the maxed-out lender) and JPMorgan Chase (the wiped-out venture investor) into contributing an additional \$1.75 million that was beyond what they were contractually required to fund, and something they are unlikely ever to get back. This was not a legal action; it was a series of political threats regarding loss of valuable state and city business opportunities and inquiries into the use of federal bail-out funds. If this becomes the norm, where political factors cause lenders and corporate investors to no longer have limited liability, it stands to reason that the cost of capital will increase tremendously as capital providers build in reserves for the unanticipated social issues they may end up funding.

The "solution" arrived at in the Republic Windows and Doors case would not have been forced on Republic's capital providers if the case were in bankruptcy court. If bankruptcy judges are pressured, or bankruptcy laws are changed to make capital providers liable for more than the amount of the capital they contracted to provide, then expected values for a wide range of probable outcomes will have to be factored into the cost of capital calculation.

As insolvency promises to be one of the predominant economic themes of the coming year(s), and issues of how to allocate scarce capital, how financial losses will be allocated, and what a fair or reasonable rate of return for different priorities of stakeholders should be, look to both bankruptcy court and bankruptcy legislation to significant impact how we calculate the cost of capital. **VE**

It has been suggested that the 1980s savings and loan industry collapse is a good comparable model to use to figure out where we are today, but I am not convinced of that. The 1980s also began the boom of tremendous foreign investment inflows into the United States. Today foreigners at best seem to be slowing down those investments and at worst taking their money back and going home with it. With real rates of return being negative, who can blame them? If international capital flows remain volatile, it may be necessary to factor these capital movements into the cost of capital build-up, either as part of the capital availability factor or separately.

Coincidental with the likely slowing of capital inflows into the United States, the country faces a huge generational issue that may impact how we look at capital costs. Up until now, each working generation has been bigger than the one preceding it. The baby boomers have provided the largest number of both productive workers and “hypothetical buyers” that we have ever seen. Now that they are retiring (with retirement portfolios significantly less than expected), demographic changes are likely to alter many aspects of the way companies are financed—preferences for ownership interests over debt claims, desired dividend distribution policies, preferences for smaller vs. larger companies, preferences for value vs. growth investments, etc. Japan, America, and Europe are all seeing decreases in the number of people still generating income and savings to inject back into their economies, in sharp contrast to earlier periods of population growth. Strong demographic shifts may cause us to rethink the relevance of historical data and the time periods used in the data tables we now rely on.

Future Prospects

Questions abound. Will we soon need a line in our build-up models for currency risk, as the U.S. government prints more dollars and goes deeper into debt bailing out its sick economy? Will our investment banking industry regenerate, or will there be new models of capital pricing and allocation? Will the government remain the major source of capital, and if so, will we need to price environmental and other societal factors that Congress mandates into the cost of capital? Will capital allocation become socialized as politicians decide which industries and employee groups to bail out and which ones to leave to the bankruptcy system?

I don't believe we are in “just” a credit crunch or a recession; I think this is a once-in-a-lifetime, massive liquidation cycle, which could take years to play out. We are likely to see higher taxes, higher government debts, shifting ratios of productive to non-productive members of the population, shifting preferences of foreign investors, deflation followed by higher inflation than we have seen in decades (if ever),

and significantly more government involvement in the economy. The U.S. will probably morph from a consumer society to a saving society. All of this portends major reallocations of capital.

A long-term, systematic under-pricing of risk was one of the contributing factors to the current economic crisis. It is incumbent on valuation professionals to consider all relevant factors, many of which have not been traditionally independently considered up until now, in pricing the cost of capital. It may become necessary to try to identify and isolate these factors, so that as their relative importance shifts during periods of economic upheaval and eventual stabilization, the historical data that we currently use can be more quickly adjusted to real-time changes in the marketplace.

When the government is manipulating the market and exerting as much influence as it currently is, the market cannot be considered efficient. When credit markets seize up, and fear and government policy become the predominant market-drivers, bond yields and stock tables do not accurately reflect the true cost of capital. Unless markets calm down quickly, valuation professionals using cost-of-capital-related methods need to focus much more intensely on both macro-economic factors and politics than we have in the past.

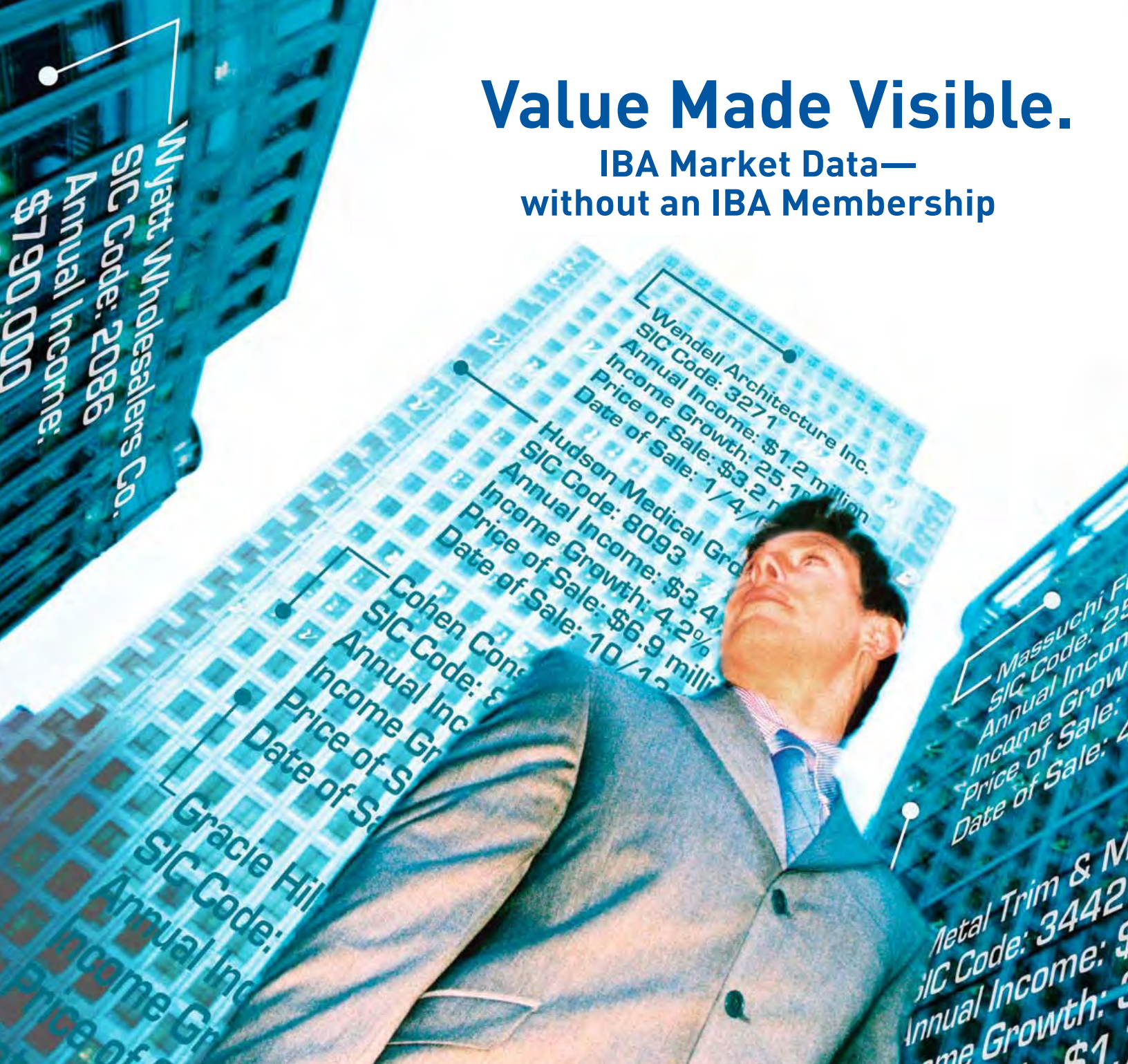
In times of rapidly changing market dynamics, professional valuers may also face tensions between what reflects current market reality and what is considered “accepted methods” under *Daubert* standards. Despite the *Daubert* dictum to adhere to doing what has been done in the past, we are in a period with no historical precedent. We cannot perform business valuations today looking only in the rear-view mirror. Just as the FASB altered one of its unalterable principles when it no longer considered the U.S. dollar a reliable measuring stick of value, we need better ways of measuring the cost of capital in chaotic markets. A valuation professional walking into court today with just the standard historical data tables does so at his or her peril. **VE**



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