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Summer 2014 Newsletter

ASA NY Chapter Current Topics in Business Valuation Conference

I attended 12 of the 25 past annual conferences as part of my continuing professional education [CPE] requirements. This newsletter will review three key 2014 presentations and provide comments on another recent BV seminar.

Practical DLOM[1] Practice Aid To Be Available Soon

A well-known, published practitioner announced that he will soon release a *DLOM Guide & Toolkit*, acknowledging his debt to both FMV Valuations[2] and to the IRS, whose treatise on the subject was leaked in 2009. However, unlike the IRS, whose work product was extensive and covered most published, even obscure methodologies, the guide will only focus on practical, working solutions. He also provided what I believe is the final death knell for using pre-IPO data to develop a DLOM. Running through recent examples of companies having been brought to market, he concluded that what the data shows has little, if anything, to do with DLOM.

On the other hand, restricted stock studies keep getting the nod, providing the data is used with a number of precautions: [a] overall market averages should no longer be used since the underlying data has been lost and most sample sizes were small; [b] a 3 stage process is recommended[3] augmented by a analysis of the relevant database data by quintiles. The analysis consists of matching the subject company with restricted stock issuers with similar fundamental characteristics such as revenues, market value. A weighted approach of the relevant quintiles is recommended, as well as a reasonableness test using the implied rate of return. Also recommended were an alternative option-based method and the Mercer QMDM, in the end comparing the methods and their applicability to the subject.

Second Fairness Opinions, Anyone ?

Given the legal climate which often leads to litigation around most of the mergers

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[1] Discount for lack-of-marketability.

[2] FMV Opinions, Inc. sells a database of restricted stock transactions. Pluris sells a similar product, which the writer uses for DLOM analysis.

[3] It starts with the restricted stock equivalent discount stemming from the transaction sample [RSED in both FMV and Pluris parlance.] The second stage consists of backing up the market volatility components [ARSED or RSED] by reference to, for example, the ^VIX index. Finally, a private equity discount increment [PED or PEDI] is added reflecting the private nature of the subject firm.

except the very smallest, the practice of hiring an independent valuation analyst without any involvement in the transaction makes more and more sense. Most mergers are "vetted" by investment banking firms who put the deal together, providing both arranging, negotiating and financing of the transaction and, of course, are due a fee at closing. This does nothing to help the interests of shareholders. But the practice of adding a non-interested adviser without any financial stake is an excellent step to insure that your board has met the standards of care, loyalty and good faith that form the basis of the Business Judgement Rule under Delaware law.

ASA Seminar on ESOP Valuation Issues

A nationally-known ESOP practitioner led a "webinar" late last year under the auspices of the ASA and provided a useful primer on the valuation of ESOP firms. An ESOP is a tax qualified, defined contribution plan which invests primarily in the securities of the sponsor employer. "Tax qualified" refers to the available tax benefits, and "defined contribution" refers to specific contributions without the guarantee inherent to "defined benefits." When the equity is not traded, a valuation must take place annually under ERISA. ESOP advantages include: the sellers can avoid capital gains tax on their stock if structured properly; they can obtain partial or complete liquidity, including potential upside with continued participation in the business; employees accrue significant wealth over time, thus aligning their interests with all owners; tax savings improve the business' cash flow.

ESOPs are grounded in ERISA sections 408(e) ["adequate consideration"] and 3 (18) (B) ["fair market value."] In 1988, DOL issued a clarification of adequate consideration, but it remains unpublished. In 2010 DOL tried to define "fiduciary" by including all participants, including appraisers. The notice was withdrawn a year later, but should be re-issued.

ESOPs are valued using equity or Enterprise Value, defined as the value of the underlying operations, or the total value of the business to *all* providers of capital, not just shareholders. Enterprise value is equal to the market value of equity plus net debt and preferred stock. Most commonly used methods include: The Guideline Public Company method; Guideline Private Transaction method; Discounted Cash Flow. When using market approaches to value, particularly the Guideline Public Company Method, adjustments to the derived market value may have to be made to reflect size, growth characteristics, geographic diversity, customer concentration, management strength, access to capital market, etc.[4] The DCF method includes the following steps: develop a historical perspective and management's projected results and free cash flow; develop a cost of equity using established methods such as CAPM or build-up, develop the cost of debt and a target capital structure in order to calculate the weight-averaged cost of capital; develop the terminal value based on a multiple of terminal year or the perpetual growth method; discounting [using the WACC] of free cash flows and terminal value. At this point, it is customary to perform a sensitivity analysis, interpret the results and adjust for non-operating assets or liabilities.

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[4] In 2012, firms with revenues of $100-250 million sold reflecting an enterprise value of 7.5 times EBITDA; firms with revenues of $50-$100 million sold at 6.8 times EBITDA; firms with revenues of $25-50 millions sold at 6.1 times and firms between $10 and $25 million sold at 5.6 times.

The conclusions of value should be weighted according to whether they are relevant to the various levels of value, the ESOP tax shield, synthetic equity such as options, warrants, phantom stock, the ESOP repurchase obligation, the S status versus C issue, and the lack-of- marketability relative to the public markets. Discounts and premia must be carefully determined in an ESOP. Synergetic value is consistent with control value, except that it includes the power of existing management to make policy. It does not reflect a buy-out if one is proposed with the resulting synergies. In a consolidating industry, all potential buyers may be synergistic buyers; accordingly, control FMV may reflect all synergistic value. Premia often reflect factors which are not part of FMV. If no improvement can be made after control is obtained, there is no reason for an acquirer to pay a higher price than the publicly-traded price.

IRC section 409(h) requires closely-held companies sponsoring an ESOP to re-purchase ESOP stock from departing employees at the then FMV. That put right makes the ESOP stock somewhat more liquid for the participants. Many appraisers consider that right to partially or totally offset the discount for lack-of-marketability which would apply.

Second Stage ESOPs generally involve a re-calculation of the entire structure. ESOP contributions can be made in cash or in stock by the sponsor, which in both cases creates an accounting expense. The level of contributions must have a bearing on qualified payroll and normal benefit plan expenses. Accordingly, contributions may have to be normalized.

Starting in 1998, ESOPs are permitted to invest in S corporations. Profits attributable to the ESOP's ownership of stock in an S corporation are not subject to federal [and most state] income tax. Accordingly, a 100% ESOP-owned S corporation is a tax-free entity, leading to accelerated debt service, higher capital expenditures to fund growth opportunities, cash for acquisitions and accumulation of excess cash. The ESOP debt tax shield results from the deductibility of plan contributions, a benefit not otherwise captured in the valuation analysis; accordingly, a separate DCF of the tax shield is performed based on the remaining principal repayments times the effective tax rate discounted at the cost of capital appropriate for the cash flows.

The re-purchase obligation can be done in 2 different ways: the sponsor may cancel the repurchased shares or redistribute them. Appraisers have shown little agreement on how to measure the re-purchase obligation. Possible methods include selecting a higher discount rate, or reducing future cash flows by the amount of "above-market" ESOP contributions associated with the repurchase, or subtracting a liability equal to the present value of future share repurchases. The choice may depend on management's target benefit level, historical and projected benefit expense, maturity of the ESOP, and other factors. Synthetic equity securities impact the entire valuation, and would typically be based on the documentation, and whether they were taken into account when the ESOP was valued. ESOP inquiries are welcome.

Private Funds Audited by the SEC

A New York area accountant with substantial experience advising private funds such as equity and private capital funds reported on the SEC's effort to audit them.

Since October 2012, such funds are required to register with the regulator. Of course, the effort is largely perfunctory since the SEC only audits the process by which funds inform investors of valuation developments. Half of the audits resulted in deficiency letters and most of the issues encountered are valuation related, often resulting from the various departments of the firms managing these funds interpreting an investment differently. The SEC is still not looking into the several issues likely to be encountered in the administration of admittedly difficult to value investments vehicles; it is, however, likely to do so soon. True, investors in the funds are mostly accredited investors who should know better, but I feel sorry for them after hearing how basic information is routinely obfuscated, perhaps even willfully!

J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business community from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key development in BV which appear to affect users. Court decision analysis is prepared from the perspective of a BV analyst, not from that of an attorney.

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