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Duff & Phelps recommends ERP decrease to 5%

D&P has recommended, for valuations effective September 5, 2017 and until further notice, that the Equity Risk Premium be reduced to 5% - previously, it was 5.5%. This is to be used in conjunction with a normalized, risk-free rate of 3.5% which is unchanged. Accordingly, the base rate U.S. cost of equity capital becomes 8.5%, which does not include any enterprise-specific risk or size premium.

The Valuation of Franchised Businesses

Franchised businesses have a number of characteristics which non-franchised businesses do not have, and they need to be considered when valuing the franchised business. A recent seminar proposed the following concepts/points, which certainly need to be thought about and discussed.

* Empirical data generally shows that a franchise is worth more than a similar firm which is not franchised.

* The franchisor's right to sell over the internet, which is becoming more prevalent, may cut into the business of the franchisee depending on how the arrangement is structured.

* There is a strong imbalance of power between the franchisee and the franchisor, which typically has significant control of the franchisee's operations.

* Many franchise agreements state that the franchisor owns good will, but the franchisee's specific goodwill determination can become an issue.

* Auto dealerships are quite different from other franchises; recent industry high sales, a booming business, expected lower regulations and other factors have made auto dealerships different, despite some clouds.

Management's projections are viewed skeptically by the Courts

The following recent case decisions in various fields from bankruptcy to statutory valuation and divorce, all suggest that the Courts are often skeptical of projections no matter who authors them.

In re: Petsmart, Inc. The Delaware Court of Chancery, in a statutory appraisal decision, adopted the merger price as the fair value, calling the management's projection "fanciful, at best." Management had no experience preparing long term projections.

Lund v. Lund In a court-ordered buyout, a Minnesota court actually performed its own DCF analysis to value of chain of high-end grocery stores. The court found the bottom-up management projection had proven reliable in the past, and it did not approve of "after-the-fact adjustments" made by the defense expert. The court also chided the plaintiff's expert for not relying on the projections to develop the long term growth rate.

Brundle v. Wilmington Trust One of the major issues in this controversial ESOP case was the reliability of management projections underlying the ESOP financial advisor's valuation. The opinion found the trustee liable for causing the ESOP to overpay. The court said the trustee's approach to management was "lackluster," i.e. the trustee should have been more forceful and questioned the reliability of the projections when management stood to gain from the transaction, management had prepared several projections, none of which accounted for contract concentration.

DFC Global Corp. v. Muirfield Value Partners In overturning a 2016 statutory appraisal decision by the Delaware Court of Chancery, the Supreme Court of that state questioned the integrity of the court's DCF analysis, in particular with respect to post-trial and unlitigated changes made to the projection reflecting working capital and growth rate. The Supreme Court noted that the projection reflected strong growth higher than the record of the company in the short term period before the transaction. The Supreme Court recommended the trial court use the transaction price as the best evidence of fair value.

IRC Section 2704 Regulations Disappear with the New Administration

Four months after the Trump administration took office, the IRS abandoned its long-fought for regulations, to the relief of business appraisers and others. The reason given by the service is that the regulations would have been too onerous. In fact, they were also inconsistent with the concept of fair market value and would have destroyed much equity in family-owned business. The proposed regulations were described in the Fall, 2016 issue of this newsletter. Good Riddance!

Law Firm Goodwill at the Heart of New Jersey Appellate Ruling

In Slutsky v. Slutsky [2017 N.J. Lexis 120 decided August 8, 2017,] the husband owned an equity interest in a large law firm. The husband/lawyer practiced in the field of tax law, and his business was referred to him by his partners [no business generation;] he generated billable hours, however, consistent with those of a top tax attorney. The firm calculated partners' interests by use of a termination credit account or TCA; its annual increase was based on the firm's excess earnings, as allocated to each partner. In 2013, the husband reached a key milestone, and was, under the shareholders' agreement entitled to receiving his TCA account over 4 years, plus a bonus equal to 25% of earned salary for longevity. The wife's expert decided there was a separate goodwill interest to the tune of $1.8 million beyond the TCA.

The trial court agreed with the wife, stating that it was "incredible" that no additional goodwill was in evidence. The appellate court criticized the trial court, indicating that it did not analyze the facts, did not support its conclusion and other inconsistencies. The appellate court reversed and remanded, and provided a review of state goodwill jurisprudence. It also ordered the case reassigned to a new trial judge; the latter's future judicial opinion should make fine reading.

What Else can Business Appraisers Do To Help?

Many business appraisers are known for regulatory work [IRC 409-A, Estate & Gift tax, FLP and ESOP valuations;] and reporting work [purchase price allocation (Note 1) and goodwill impairment;] and advocacy [litigation (Note 1), expert testimony, IP infringement (Note 1), divorce disputes and bankruptcy.] JLP&Co.LLC has completed many of the above types of common assignments except those marked (Note 1).

Based on personal experience, the following types of assignments have also appeared in the market. They are more challenging and rewarding to the appraisers and clients. Corporate finance skills and adherence to a well known set of rules such as USPAP suggest trusted guidance to the clients.

* Transactional opinions, such as fairness, solvency and financing opinions.

** Consulting assignments, such as corporate strategy, value growth and M&A planning. Clients, particularly the mid-market firms, appreciate the advice of an independent, time-only fee financial specialist on how to grow.

*** Transactional services, such as ESOP planning and general capital raising in connection with a traditional investment banker.

Should this ring a bell or two, please contact JLP&Co.LLC.

J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business communities 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 and corporate disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key development in BV which may affect users.

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