

J.L. PIERSON & Co. LLC

VALUE ADDEDTM

ROUTE TO:

J.L. PIERSON & Co. LLC
BUSINESS VALUATION
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<http://www.jlpierson.com>

Post Office Box 2392
Darien, Connecticut 06820-0392
Telephone/Fax: (203) 325-2703 • e-mail: jlpierson.com

Buy-Sell Agreements

The Three-Appraiser Pricing Mechanism

Buy-sell agreements among shareholders of privately owned businesses have to provide for a valuation mechanism in the event that their "buy" or "sell" provisions are triggered. We have found that the majority of buy-sell agreements have several things in common, including:

- The initial value for the agreement is established at the outset.
- The agreement calls for annual or periodic updating of the value.
- The periodic update valuations seldom occur.
- When events give rise to requirements for a valuation and the parties have not agreed, the latest valuation generally favors the buyer if the value of the business has been rising.
- In the alternative, the agreement calls for a "formula valuation," citing a multiple of book value, a multiple of earnings, or some other mechanistic determination. No "formula valuation" will provide a consistently reasonable valuation indication for a subject private company over rapidly changing market circumstances.

A three-appraiser pricing mechanism for a buy-sell agreement is a cumbersome, time-consuming and expensive way to determine value

Most agreements are designed with the idea that the other person will die first. An agreed-to value that becomes outdated with the passage of time will tend to favor the party(ies) who survive. For example, a controlling shareholder may favor a low buy-sell price because it facilitates the acquisition of minority blocks of shares. The minority shareholder(s) might also favor a low price with the thought that the controlling shareholder may die first. In any event, the failure to update the pricing of buy-sell agreements that call for periodic revision will inevitably cause problems for one side or the other or both.

Many buy-sell agreements have different valuation mechanisms, whether automatically built into the agreement or triggered by events enacted by the provisions of the agreement. We can call this the "one-appraiser, two-appraiser, three-appraiser valuation

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An Interesting Divorce Valuation

With the preeminence of options in the corporate world, and the emergence of "reporting" but non-listed corporations [often those issuing "junk bonds" to the investing public], private company analysis, research and valuation now rely more on the tools developed by analysts of public securities.

My facts were as follows. An executive had taken three divisions of two public corporations, including the one he had managed and grown for years, private in a leveraged buy-out transaction. In order to finance the transaction, the executive took as equity partners one of the selling corporations and an investment bank. Both bank debt and publicly traded subordinated debt were used to finance the balance.

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mechanism," or, for short, the "three-appraiser pricing mechanism." This multiple-appraiser option typically goes something like this:

- The one-appraiser valuation mechanism: The company hires an appraiser, who provides an opinion of value for purposes of the agreement. If the parties agree on the value, this may be the end of the process. But if they do not agree . . .
- The two-appraiser valuation mechanism: The shareholder(s) hire a second appraiser. Sometimes the second appraiser is hired concurrently with the first and sometimes after reviewing the first appraisal. Now the parties (or sometimes the appraisers) have an opportunity to look at two appraisals and to negotiate, or agree on a value. If the parties agree on the value, this may be the end of the process. But if they do not agree . . .
- The three-appraiser valuation mechanism: It is now time to hire a third appraiser. The usual mechanism calls for the first and second appraisers to get together and agree on an acceptable third appraiser. Some agreements call for the third appraisal to be binding on the parties. Others call for some form of averaging process (of either all three appraisals, or of the two closest together).

Another form of the three-appraiser mechanism occurs when a court, seeing disparate values from two appraisers, suggests that a third appraiser be appointed. The court can then make a decision based on the third appraiser's conclusion(s) or by some averaging process from the three conclusions.

A three-appraiser pricing mechanism for a buy-sell agreement is a cumbersome, time-consuming and expensive way to determine value. As an alternative valuation mechanism some attorneys are writing a single-appraiser option into buy-sell agreements. It is becoming

increasingly common for the shareholders of companies to agree on an appraiser to provide the initial valuation for purposes of the agreement and then to provide revaluations on a scheduled or as-needed basis.

Please call if you have any questions or to discuss a valuation of a buy-sell agreement in confidence. ♦

An Interesting Divorce Valuation

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The bank debt, incidently, was rated by the rating agencies one notch higher than the subordinated debt, in view of the first lien security on all corporate assets provided to the bank group. A fairly common occurrence thus far, except that through its public issuance of subordinated debt securities, the new entity was publicly reporting. As a result, 10-Ks and other financial documents were available to the public, including the business appraiser.

The rating agencies' analytical work and conclusions are also public for the most part. This provided yet another source of rather detailed information about the new group, its background, its clients, its management, its properties, its prospects, its business plan, and eventually its quarterly results. Not only is the agencies' work product public, but as part of their service the agencies like to proselytize about their clients, and one can even call their analyst and learn quite a bit about the

company and its debt rating. Overall, a good deal more information for the appraiser to work with than is normally available for private companies.

The executive received stock and stock options equal to as much as 10% of the company and it is clear that the LBO investors's exit strategy was to take the business public as progress was made and equity market conditions became favorable. Six months into the LBO, the executive is divorcing his spouse.

On the date of valuation, which was stipulated by the parties to the divorce, the entity was private, and financials covering six months since its inception were on file at the SEC. Only 9 months after the valuation date, the company would take advantage of the strong bull market to make an initial public offering, and the stock was listed. I got involved in the

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case at the request of the wife's attorney about six months after the chosen valuation date, i.e. before the stock started trading.

Given the stipulated date, all subsequent information, including some improved earnings and valuation

multiples could not be used in the valuation. However, subsequent information such as the price of the stock once it began trading, certainly could be used as corroboration of the earlier value.

Using the actual results of the first 6 months of operations, the valuation made a case for normalized annual earnings. Such could then be capitalized and give us the first indication of value. Even after backing up the substantial debt, an equity value 2-3 times book value was in evidence.

When management was inducing a bank group into financing the LBO, it prepared projections reflecting its anticipated cash flow. That projection was used by the appraiser as the raw material for a discounted cash flow analysis ["DCF"] which also yielded a value, albeit a relatively low one because management had been conservative when addressing its bankers. The raw data was updated for the actual results known as of the valuation date, with subsequent data evidencing the growth supported by management. This time the DCF yielded a value more in line with the value shown by the capitalization of earnings.

Clearly, the guideline companies approach was also called for: here was a sizeable firm with [through its predecessor firms] a long history in the business, an experienced management, and an industry with several large public companies whose price is marked to market daily. Certainly the price of these public companies as of the valuation date could be used to calculate the price of the new entity if it had traded then. The group of guideline companies was chosen as those listed by management as their competition. The standard analysis of the relationship between net invested capital and sales, capitalization, and several measures of earnings lead to a value for the subject's equity if traded.

The three approaches were, in effect, boxing the value, and weighting led to a number I felt was "bullet-proof." The wife's attorney was duly told that the other side was sitting on stock and options worth \$15 million, all acquired during the marriage.

If you wish to discuss a business valuation issues relating to a divorce case, please call. ♦

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Understanding the Valuation Process

The process of business valuation is often new and challenging to clients, so we thought it would be helpful to provide some elaboration on the *valuation process* to make the experience less intimidating when the need for these services arises.

It has been our experience that few business owners have their company appraised just to satisfy their curiosity about value. Typically, a specific event will precipitate the need for a business valuation, such as the death of a shareholder, an estate planning need, the formation of an Employee Stock Ownership Plan (ESOP), satisfaction of a buy-sell agreement, some litigation experience or other event normal to the life cycle of a business and its owners.

Business owners can plan for and control some of these events to minimize the surprise factor and maximize value for the shareholders. An estate tax appraisal cannot be timed precisely without divine foresight, but effective estate planning, using valuation resources, can help minimize the estate tax bite. Selling the business may be a once-in-a-lifetime event, but ensuring that the business is ready for sale and presenting its valuation attributes in a coherent and positive manner to prospective buyers is a timing device that can be implemented over time, clearly to the advantage of the seller.

Most business owners discuss these precipitating events routinely with their professional advisors. In turn, the advisor, typically the attorney or the accountant, will contact a valuation professional on behalf of their client to begin the valuation process.

The Introductory Phase. During the introduction, we will request certain descriptive and financial information (usually recent audits and marketing brochures) to help determine the scope of the business. Defining the

project is a critical phase of the business valuation and can be accomplished with telephone and personal visits.

The Engagement Phase. Once the valuation project has been defined, we will issue an Engagement Letter or Proposal setting forth the key elements of the appraisal assignment,

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SPEAKERS' BUREAU

This firm often participates in local and national speaking engagements, which include group seminars and speeches for attorneys, CPAs, CEOs, and other financial advisory professionals interested in topics relating to *Business Valuation*.

Please call for further information or to discuss a specific speaking engagement.

including the name of the client, the name of the person or entity responsible for accepting the assignment, the official name of the entity to be appraised, its state of incorporation or organization, its principal business location and the specific business interests to be appraised. Additionally, the Engagement Letter will indicate the appropriate standard of value (often, fair market value), the premise of value, the effective date of the appraisal, and the type of report to be produced. The Engagement Letter or Proposal will also provide a descriptive project overview, the qualifications of the appraiser and the timetable and fee agreement.

Often accompanying the Engagement Letter is our comprehensive checklist request for information. This checklist requests the company's historical financial statements along with operating and structural information about the business and the market in which it operates.

The Valuation Phase. Once the checklist has been completed we begin our preliminary analysis of the

company, which includes appropriate industry background research. We recognize that an appraisal of common stock represents an appraisal of the future at a current point in time; however, most of the information available to the analyst is historical. The future will likely change relative to the past, and we know that management will play an important role in making that future happen.

Accordingly, upon review of the checklist and industry information, we will schedule an on-site appointment with management to discuss the operations of the business. The company visit provides an important perspective to the business valuation since it puts us in direct contact with the individuals responsible for shaping the future performance of the company.

During the on-site or due-diligence visit, we will: (1) review in detail the company's background, financial position, and outlook with appropriate management personnel, (2) review appropriate corporate documents not normally exchanged by mail, (3) tour

the operations, and (4) respond to questions from management.

Following the due-diligence visit the analysis is completed, making specific documented adjustments discussed with management, in context with more subjective conclusions involving the weighting of some factors more than others. The client's review of the draft report is an important element in the process. It is important to discuss the appraisal in draft form with management to assure the factual correctness and to clarify any possible misunderstanding from our company interview.

Upon final review the valuation report is signed by the major contributing appraiser, and is reproduced in sufficient number for the company's distribution or documentation requirements.

If you have a prospective valuation assignment you would like to discuss in confidence, please give us a call. ♦

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J.L. PIERSON & Co. LLC

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Post Office Box 2392
 Darien, CT 06820-0392
<http://www.jlpierson.com>