

Exit Strategies & Business Valuation

Ralph Consola
Principal

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A Leader in Valuation and Transaction Advisory

- ❖ Founded and Headquartered in Los Angeles since 1932
- ❖ Full-service, independent valuation consulting firm:
 1. Fairness and Solvency Opinions
 2. Business Valuations and Partial Interest Analyses
 3. Financial Valuations
 4. Real Estate Valuation
 5. Machinery & Equipment Valuation
- ❖ Transaction and Consulting



A National Firm With International Capabilities



Valuation and Advisory Services

- Fairness Opinions
- Transaction consulting and due diligence
- Business and business unit valuations
- Partial interest (“Discount”) analyses
- Wealth transfer/Succession planning advisory services
 - ❖ *including ESOP formation and financing*
- Discounted stock, stock options, warrant and derivative valuations
- Solvency Opinions
- Financing and restructuring transactions
- Purchase price allocations (SFAS 141R, 142, 157)
 - ❖ *tangible and intangible assets*
- Intangible asset valuations
- Property tax valuations
- Insurance Placement and Proof of Loss valuations
- Litigation/Expert Witness

Hot Valuation Issues

1. **SFAS 141R and 157:** The standards have changed. Deals will be affected.
2. **Valuation of earn-outs** for tax reporting, purchase price and planning.
3. **SFAS 141 for Real Estate:** The old 80/20 rule no longer applies.
4. **IRC 409A, SFAS 123R:** Valuation of derivatives and stock options.
5. **Goodwill Impairment (SFAS 142)** – Down market, down market value.
6. **Solvency:** Can companies support the new leverage?
7. **Independent Fairness Opinions:** Of course the IB thinks the deal is fair, what would an independent third party say?

These issues are not just for public companies!

These are issues for all GAAP reporting companies



Selling (shares in) the Private Business

By Choice

- ❖ Opportunity came calling – *Sales or Merger presents itself*
- ❖ Strategic – *Consideration in Acquisition or Merger*
- ❖ Retirement
- ❖ Diversification of Capital – *Taking some chips off the table*
- ❖ Wealth Transfer
- ❖ Promotion/Participation of Employee(s)
- ❖ C to S Conversion
- ❖ Reincorporation

By Circumstance

- ❖ Death
- ❖ Divorce
- ❖ Shareholder Dispute
- ❖ Recapitalization – new debt, pay dividends, buy-back stock
- ❖ Restructuring



Valuing the closely held/Private Business.

What are the traps for the unwary?

How can you best make use of a Valuation
Expert?

The Sale



- Selling the Business means selling what? *Assets or Stock*
 - ❖ What can actually be sold?
- What is it all worth? How was the worth determined?
- What is the magic number?
 - ❖ Is the plan to sell all of the business or just a piece? If a piece, how big of a piece? (*\$ vs. %*)
- Are gifting of shares to a charity or family a consideration?
- What does the seller want to receive in return for the sale?
Cash, Stock, Promissory Note, Legacy?
- Does the owner want some or all employees to benefit from the sale?
- Are key employees/shareholders willing to stay involved after the sale?
- Is a sale to an employee(s) preferable?

Valuation Scenarios?

Valuation analyses are provided for scenarios – *values may differ*

- ❖ Wealth transfer
- ❖ Sale to a Strategic vs. PE vs. Public Co.
- ❖ Sale of a Subchapter S to a C
- ❖ C Corporation to Subchapter S election
- ❖ ESOP Formation
- ❖ IPO



It is important to understand the differences and to get what you need. This requires planning and consideration of options.

- ❖ Tax implications, personal and corporate, of the “preferred” transaction?
 - Are you speaking with tax counsel as well as corporate counsel?
 - What have the discussions been with your personal wealth advisor?

Don't chase multiples and rush into a transaction.

Finding/Creating the Right Transaction

❖ Sale

- Private sale: Strategic v. Private Equity
 - Broad Auction v. Controlled Auction v. Sole Source
- Management Buy-out
- Family Transaction
- Public entity
- Employee Stock Option Plan (ESOP)

❖ Considerations

- Distribution of surplus equity
- Intergenerational Wealth Transfers
- Welfare of Employees
- US Department of the Treasury



Scenarios and Options

A valuer can provide the scenarios and analyses needed to help determine how to get the most value for the business enterprise.

- ❖ What is the “value” of the company today? What could it be in the future?
 - *In the case of corporate real estate, why include it in the sale?*
- ❖ Who are the natural buyers and what are they going to be looking for?
 - *Intellectual Property, Capital, Customer/Vendor Relationships, Tradename, NOL, Retire a Competitor*
- ❖ How does the subject compare to its competitors in key areas?



Enhancing *Value* Before Ownership Transfer

What can be done in the short run to build value?

1. Identify areas to focus to increase value (*value drivers*)
2. Show greater earnings for the business by divesting non-operating assets or non-performing lines of business
– *Profit over Revenue.*
3. Pursue accretive acquisitions
4. Groom or hire potential successors
5. Transfer/build institutional knowledge and relationships
6. Lock in key employees, and their value, with a multiyear contract
7. Remove non-operating assets (cars, property, etc.), excess salaries and expenses, or non-performing lines of business from the books.



Business Enterprise Value

Valuing a Business Enterprise – Should consider the three typical approaches to value as they apply:

1. **Cost** – Adjusted Book (Asset Value)
 2. **Market** – Public and Private market transaction multiple
 3. **Income** – Discounted cash flow
- How does a buyer support a 10x EBITDA multiple? Cash!
 - The range is 6-10, are you a 10, a 4, why?
 - What is the buyer seeing that the seller is missing?
 - Efficiencies vs. Synergies

TTM EBITDA x Market Multiple is not sufficient!

Partial Interest Analyses

Valuing a Partial Interest means considering factors that may restrict value for a less than 100% interest:

- ❖ Marketability, Control, Customer, Concentration, Key Person(s), etc.
- ❖ Minority Discount in inverse of Control Premium: $MD = \frac{CP}{1+CP}$

Is making case law your goal?

Stock Option Valuations (SFAS 123R/IRC 409A) requires valuing the business enterprise on a minority interest basis before utilizing market and entity specific data to run stock option valuation scenarios:

- ❖ Black-Scholes, Monte Carlo, Binomial Lattices.

What does the IRS like to see: *More is better!*

Efficiencies and Implications to the Analysis

Having a business valued for one purpose (wealth transfer, stock options, fund raise, etc.) sets a basis for future transactions.

- ❖ It is a starting point for future analyses. Efficiencies should exist with the consultant.
- ❖ The report can also be considered a **consulting document**:
 - How does the subject business compare to others within its market?
 - What are the industry and economic forecasts?
 - What were the recent comparable transactions multiples? Why?
- ❖ How does the value conclusion affect **financing** pitches?

*If the business value is down/(low),
now may be the time for gifting or selling to related parties!*



Is a Valuation Opinion Really Needed?

Liability exposure for a director in a private company deal (*merger, acquisition, divestiture, recapitalization*) may be greater than in a big public company context, due to:



- ❖ Absence of a liquid market or other benchmarks to test value.
- ❖ Personality issues may predominate over economic issues
- ❖ Seller's remorse factors
- ❖ The Tax and Accounting issues are oftentimes the same, specifically for companies that have public investment or large bank debt.
 - If anticipating an IPO or sale to public company, these issues will come up in future

Transaction Liability

1. Director Liability:

- ❖ Did the director act in the best interest of the shareholders?
- ❖ How was the price determined?
- ❖ Did the price change due to:
 - Poor planning
 - Poor due diligence
 - Not understanding the impact of new accounting regulations
 - Poorly negotiated earn-outs
 - Other?

2. Tax and Reporting issues:

- ❖ Purchase Price Allocations - SFAS 141R
- ❖ Stock Options compliance - IRC 409A and SFAS 123R
- ❖ Subchapter S Benchmarking
- ❖ Goodwill Impairment – SFAS 142
- ❖ Ghost Assets



The Valuer's Role in Transaction Situations

- Help client and counsel to develop a cost effective (tax efficient) structure and to anticipate and tackle valuation issues efficiently (earlier is better).
- Work with counsel to provide comfort to directors, lenders and persons receiving consideration (distributions) that applicable legal tests are satisfied (Fairness Opinions, Solvency Opinions and transactional due diligence).
- Work with client and counsel to document the tax case and conform with ever changing accounting rules.
- Work with auditor and other advisors to increase efficiency (reduce fees).



Sale to Strategic or Financial Buyer

Expert in the subject business does not correspond with expert in sale of the business.

- ❖ Understand how transaction multiples apply – *are you a 9 or 4?*
- ❖ Understand the value of the investment – *don't sell a majority share for minority money*
- ❖ Understand the implications of warrants and derivatives – both on ownership (dilution) and on reporting (audit)
- ❖ Have a valuation expert review the draft deal provisions to determine the probability of reaching earn-out milestones.
 - Is the cash with an earn-out offer better than the cash plus stock offer?
 - What is the probability of realizing the future consideration?
 - What is the exit plan for the investor? Do you agree?
 - The other side will most likely use transactions experts, why wouldn't you?



Fairness and Solvency Opinions

What are you getting in exchange for the fee?

What is a Fairness Opinion?

What is it not? The Limitations



An opinion to the Board of Directors (or an Independent Committee of the Board) by an independent financial advisor stating that the transaction is fair, from a financial point of view, to the company's shareholders.

- ❖ A Fairness Opinion does **not** constitute **a recommendation to shareholders** as to how they should vote on any action.
- ❖ It does **not opine** as to the **fairness of the process** or whether the **price is the best** price that could be achieved.
- ❖ It does **not** advise that the transaction being considered is the “**best**” **transaction** for the company and its shareholders. For example, does **not** take into **account** **alternative tax strategies**.
- ❖ **Board of Directors maintains full responsibility** for recommending what is in the best interest of the shareholders and for retaining legal counsel to advise on the transaction.

Depending upon the situation, transactions requiring fairness opinions include: mergers, acquisitions, divestitures, sale of securities/assets, among others.

Solvency Analysis and Opinion

Determine how much debt a company can efficiently carry:

- ❖ **Prepare proforma calculations** (Conservative through Aggressive) and run them against potential financing scenarios.
- ❖ **Understand how warrants, derivatives, non-dilutive and convertible features can affect value and ownership.**
 - What are the reporting requirements (SFAS 123R) – are quarterly or annual valuation needed?
- ❖ Is the debt for **personal liquidity**? How else can this be achieved (ESOP)?
 - Once the value of the company is dampened due to the increase in debt, should gifting be pursued?



Private Company Examples

Fairness

1. Regional Bank with Country Club Capital
2. Sale of ESOP Company – employees as shareholders (litigants)

Solvency

1. Family-owned Construction Industry Business
2. Private Equity Recapitalization of Apparel Company
3. Technology Company
 - Combined multiple subsidiaries into two entities before recapitalization and sale to Private Equity.

New Accounting Requirements Will Change Deals Structures

SFAS 141R and 157

SFAS 157 - Fair Value Measurements

- Defines FV, establishes a framework for measuring FV for GAAP reporters and expands disclosures about FV measurements.
 - ❖ *Significantly changes how valuation professionals develop FV.*
- Corporations must understand the FV requirements and how their auditors will make them implement and maintain it
- Another step in the process of convergence between US and International Accounting Standards
- Impacts FASB: Opinions 18, 21, 28, and 29; Statements 13, 15, 19, 23, 28, 35, 45, 60, 61, 63, 65, 66, 67, 68, 84, 87, 98, 106, 107, 114, 115, 116, 124, 126, 133, 136, 138, 140, 141, 142, 143, 144, 146, 149, 150, 153, and 156; Interpretations 9, 23, 24, 45, 46, and 47; Technical Bulletin 84-1, 85-1, 85-5, 85-6, 86-2, 88-1; FSP FAS 115-1, 124-1, 143-1, 144-1, 150-1, 2, 3 and 4; FSP FIN 45-2, 46(R)-2, 3, 5, and 6; FSP FTB 85-4-1 and FSP AAG INV-1 and SOP 94-4-1

Definitions Seem Similar

Old Definition

“Fair Market Value is defined as the price for which property would **exchange between a willing buyer and a willing seller**, each having reasonable knowledge of all relevant facts, neither under compulsion to buy or sell, and with equity to both.”

New Definition

“Fair Value is the price that would be received to **sell** an asset, or paid to transfer a liability, in an orderly transaction between **market participants** at the measurement date.”

The “Day Two” Dilemma

Company buys an asset today because it is valuable to the acquirer due to synergies.

1. Cannot sell it to anyone else at that same price because the other market participants don't have the same synergies.
 - Therefore must take a Day-2 impairment charge.
2. Acquirers should plan and discuss placement of Goodwill (reporting units) in consideration of potential future impairment.
 - We can project impairments and advise how to avoid them if provided time before the deal is finalized.

Accounting Implications from 141R, Business Combinations

Date of Value

Value assets and liabilities as of the **date of close of transaction**, not as of date of announcement as is/was the case in SFAS 141, including value of stock used to make the purchase.

Potential Impact of Deals

- **Quicker closings** requiring better due diligence before announcements
- **More cash, less stock** purchases (higher cash to stock ratio)
- Share price **protections/collars**
- Buyer's stock rises = more **Goodwill** = more impairment risk and a potential hit to the P&L
- Buyer's stock drops = "**bargain purchase**" = an immediate operating gain and "negative Goodwill" = good for Income statement, not additional cash
- **Independent Fairness Opinions** required to set terms of fairness

Accounting Implications from 141R

IPR&D - No longer expensed.

- Remains **unamortized** on the books at FV and is reviewed annually for impairment
- When the life is determined, (upon completion or abandonment), will be **amortized over expected remaining life**
- *Potential Impact* = Increased EPS; More EPS Volatility; Lower Goodwill Allocated

Transaction-Related Costs

- **Expensed** and no longer included in PPA, including Legal, Banking, Accounting and Valuation services
- *Potential Impact* = Negative effect on earnings.

Contingent Liabilities and Assets

1. **Contractual** - such as warranties
 2. **Non Contractual** - such as lawsuits and environmental issues, if there is a “more than likely than not” (50.1%) chance they will occur.
- *Potential Impact* = Increased EPS Volatility

Future Payments based on Operating Results (Earn-outs)

- Must be **estimated and recorded**
- If estimate was too low (high), there will be a charge (credit) to P&L
- *Potential Impact* = Increased EPS Volatility

Purchase Price Allocations - *Traps for the Unwary*

The need to get it right the first time:

- ❖ SFAS 141R and 157
- ❖ The “contract allocation” trap.
 - **Where should the goodwill be assigned** in order to reduce the potential for an impairment in future years? (SFAS 142)
- ❖ The short-term view trap:
 - Structuring for **tax benefit of seller** without understanding the implications to the buyer
 - **Accepting the asset list** of the seller without due diligence to confirm the existence, location and condition of the assets – *Ghost Assets*



SFAS 141 for Real Estate

Purchase Price allocation for real estate investment property acquisitions now include allocations to:

- ❖ Land
- ❖ Land Improvements
- ❖ Building, and
- ❖ Four Categories of Intangibles per tenant
 1. Value of Leases in Place (above and below market)
 2. Remaining Value in Leasehold Improvements
 3. Value of Tenants in Place
 4. Customer Relationships

PPA is not a Cost Segregation

A SFAS 141-compliant purchase price allocation is not performed in place of a cost segregation analysis, or visa versa.

- ❖ Cost Segregation (MACRS) is an accelerated depreciation analysis based upon value of improvements – *tax purposes*
- ❖ Purchase Price Allocation is performed to increase transparency – *book purposes*.
- ❖ We work with CB Richard Ellis' Cost Segregation practice (formerly Marshall & Stevens' Cost Segregation) to synchronize the analyses to the benefit of our clients.

Consider Recapture and Tax Benefit to Buyer

If PPA and cost segregation is done upon acquisition, consider doing it for sale purposes:

1. It is typically the case that the increase in value upon sale is due to an increase in the value of land since improvements depreciate.
2. Can show potential tax benefit to buyer by stepping up the cost segregation analysis.

The Best Defense is a Good ... Due Diligence

To assure that there are no (few) surprises, we recommend:

1. Engage a qualified valuation firm during the due diligence period and before the deal is finalized (before the LOI?)
2. As part of Due Diligence obtain an estimate of values and lives for all intangible assets
3. Determine where goodwill may be allocated to reduce chance for impairment.
4. Test the fixed asset list (depreciation schedule) to determine potential for ghost assets.
5. Have the valuation firm speak with the audit firm to discuss purchase price allocation methodology and approaches. Have the auditor approve the approaches.

M&A Due Diligence and Valuation

Sell Side Due Diligence

- ❖ Establish likely price range
- ❖ Anticipate buyer issues and synergies
- ❖ Prepare disclosure book and organize due diligence documents
 - Prepare adjusted (market) EBITDA



Buy Side Due Diligence

- ❖ Pricing Consultation
- ❖ Physical (Fixed Asset) due diligence
- ❖ Financial due diligence

Can a Valuation Expert Bring Value?

Some clients are concerned about the expense incurred in engaging a valuation expert.

- ❖ Properly used, particularly at the beginning of a transaction, valuation experts can help review alternatives, provide insight and unlock value.
- ❖ Valuation experts are hired to determine fair market value.
 - This means they actually need to determine what the market value is and what the market is looking for under the conditions of the deal.
 - Deal structure can impact value.



Strategic Planning

Many Middle Market Clients cannot afford “in house” financial analysts or a strategic planning group. Who can they turn to in planning for a transaction?

- ❖ Accounting Firms:
 - Independence Issues
 - Expertise Issues
- ❖ Commercial Bankers:
 - Product driven
 - Expertise Issues
- ❖ Investment Banks:
 - Deal oriented
 - Different pricing model – Success fee oriented



Make sure you get the expertise you need without the limitations posed by conflicts of interest.

Questions



Thank You!

Ralph Consola

rconsola@marshall-stevens.com

213-233-1511

Marshall & Stevens

Corporate Headquarters

355 South Grand Avenue, Suite 1850

Los Angeles, CA 90071

213-612-8000

marshall

valuation consulting

stevens

CHICAGO

LOS ANGELES

NEW YORK

PHILADELPHIA

SAN FRANCISCO

ST. LOUIS

TAMPA