VALUE ADDED™ Spring, 2003

When to Call in a Business Appraiser

There are so many times when the value of a business or other privately held entity might be scrutinized by tax collectors, regulators, courts, and a myriad of other lurking adversaries. Death, retirement, change in ownership, or similar business disruptions produce various situations where valuation may be the key issue. A well-reasoned appraisal performed by a qualified valuation expert can help the client's team of professionals to properly strategize and avoid negative surprises.

Compliance issues (tax, regulatory, and legal/fiduciary compliance) trigger many needs for qualified, independent valuations of closely held securities. The familiar gift, estate and income tax issues related to minority interests, discounts for lack of marketability, intangible assets and the like. Many regulatory considerations related to transactions with ESOPs and certain (re)financings, mergers, and acquisitions. Legal and fiduciary compliance issues stem from transactions that affect minority shareholders, ESOPs, and practically any deal where a law requires "fair" treatment of parties who lack control.

Valuation services are often needed in the litigation arena. Value can be the centerpiece of much business and personal litigation. The high-stakes, hard-to-quantify issues of litigation are always aggressively challenged. Valuation analysis is often needed in the following situations:

* Arbitration - Review of opposing experts, negotiation assistance, and range estimates of value.
* Bankruptcy - Postmortem analysis, going-concern valuations, reorganization feasibility assessment, fraudulent conveyance, forecasting.
* Dissenting Shareholder Actions - "Fair value" as defined in the various states.
* Divorce - Controlling interests, minority interests, professional practices, partnerships, and valuations of publicly traded and restricted securities.
* Damages - Breach of contract, lost earnings, anti-trust, eminent domain, forecasting.
* Trial Support - Critique of opposing experts, cross examination assistance, expert testimony, economic research, public securities, market and industry research.

A valuation expert should do three things essential to assessing any questions of value, whether in a litigation or a compliance environment:

1. Focus on relevant information;

2. Draw conclusions that have economic substance; and,

3. Articulate the reasonableness of conclusions in a manner that appeals to common sense.

A business appraiser should be able to define the valuation issues, assemble the relevant information, and quantify the financial aspects of a case. Moreover, an expert should be able to communicate the soundness of conclusions convincingly.

Case Law Update

Presented below are three recent court cases involving valuation issues. The first case involves estate taxes; the second involves a shareholder litigation; and the last involves a Pennsylvania divorce. Also listed are the Internet addresses for the decisions. Some Internet sites post decisions for only a limited time. In those cases, please contact us and we will forward a copy to you at no charge.

Estate of Beatrice Ellen Jones Dunn v. CIR. No. 00-60614 (5th Cir. August 1, 2002). Full Amount of Built-in Capital Gains Tax Liability Reduces Value. Court discusses weights to be given to valuation approaches. www.ca5.uscourts.gov/Opinions/pub/00/00-60614-cv0.htm.

The U.S. Court of Appeals for the Fifth Circuit considered the Tax Court's valuation of a majority interest in a closely held, heavy machinery rental business. The decedent held a 62.96 percent interest in the corporation. It provided the decedent with operations control over the business, but lacked the supermajority needed to effect a liquidation or sale of the business.

As a result of economic conditions, cash flow of the business was at a reduced level. It was uncontested on appeal that the pre-discount value of the company under the earnings-based approach was $1.321 million; the market value of its assets before adjustment for built-in tax liability was $8.278 million. Also uncontested was the discount for lack of marketability (15%) and the discount for lack of super-majority control (7.5%). The only two contested issues were (1) dealing with the assets' built-in tax liability when determining the company's asset-based value, and (2) assigning relative weights to the asset-based and earnings-based values.

On the first issue, the Fifth Circuit determined, "We hold as a matter of law that the built-in gains tax liability of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value of the Corporation…" It reversed the Tax Court's decision and held that the full amount of the built-in capital gains taxes should be considered at the effective 34 percent rate.

In considering the appropriate weight to be applied to the asset and earnings methods, it noted that the corporation was an operating company. Its significant physical assets, namely equipment, were used in the production of income. It was unlikely that the corporation, which had been in operation since 1949, would be liquidated. It reversed the Tax Court and recalculated value based on a 85-to-15 earnings-to-asset valuation ratio.

In re Pure Resources, Inc. Shareholders Litigation, No. 19876 (Del. Ch. October 1, 2002). Disclosure of investment bankers' analyses. http://corporate-law.widener.edu/documents/opinions/19876-133.pdf

The Delaware Court of Chancery considered whether the investment bankers' underlying analyses performed in connection with its fairness opinion were material to a shareholder deciding whether to tender his shares in connection with a tender offer made by the controlling shareholder.

The Court determined, "(D)isclosure of the banker's "fairness opinion" alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability." It then reasoned that "…the retention of financial advisors by special committees is designed to offset some of this asymmetry (brought on by the majority shareholder's large informational advantages), and it would seem to be in full keeping with that goal for the minority stockholders to be given a summary of the core analyses of these advisors in circumstances in which the stockholders must protect themselves in the voting or tender process."

Thus, the court found that the underlying analyses that form the bases for the investment bankers' fairness opinions should be disclosed when the majority shareholder has initiated a going private transaction through a tender offer followed by a short form merger.

Donna K. Mackinley v. Gerald L. Messerschmidt, 200 PA Super 361 (November 18, 2002). Vested Stock Options Constitute Income Available for Child Support.
www.courts.state.pa.us/OpPosting/Superior/out/a06031_02.pdf

The Superior Court of Pennsylvania considered whether vested stock options should be includable as income available for child support. It concluded, "The value of options at the time income is calculated must be imputed to the parent who holds them. It is the parent's ability to access the funds granted by her employer in her compensation package that requires the value of those funds be considered when calculating income available for child support." The court stated that the value must be considered "regardless of whether she exercises them, a decision that is for her alone."
Different Measures of Valuing a Business

Most people can understand pricing a business or a piece of a business based on net income or net cash flow. Profits, at least in theory, can be paid to shareholders as dividends. Value is based on determining the present value of shareholder cash flow (dividends and the terminal value when the interest is sold).

Setting aside, for the purpose of this article, the topic of balance sheet values, appraisers frequently consider measures of value other than net profits. Buyers often look at EBITDA (Earnings before interest, taxes, depreciation and amortization), EBIT (Earnings before interest and taxes), or OCF (operating cash flow, defined as EBITDA minus capital expenditure requirements). Value might be measure din terms of gross profit or even revenue itself. There are also various rules of thumb and activity valuation measures (price per access line for a telecommunications company, price per bed for a nursing home, price per unique user for an internet company, etc.).

Valuation on these bases is somewhat confusing, because none of these measures (EBITDA, EBIT, OCF, gross profit, revenue) represents the true dividend paying capacity of a company. Nonetheless, they may provide meaningful information. The choice and use of these measures of value depends upon 1) the level of value appropriate for the assignment, 2) the company itself, and 3) the industry in which the company operates.

Levels of Value. Whether a valuation is being prepared on a minority interest basis or a controlling interest basis can impact the approaches utilized. The appraiser might apply the above measures (EBITDA, EBIT, etc.) if a controlling interest is being valued. If the valuation is being prepared on a minority interest basis, measures of value other than net income or net cash flow should be used with great caution.

Why? Net income and/or net cash flow, depending upon which is most applicable, represents the residual available to shareholders after all expenses are recorded and taxes are paid. It also reflects the company's capital structure (how the company is financed) and its accounting policies. Appraising a business on the basis of net income establishes value without regard to the shareholder's ability to influence any of these issues. Minority investors cannot unilaterally influence capital structure, revenue recognition methods, account of inventory, and other entries above the net income line. Hence, net profits have a particularly important meaning.

A controlling interest buyer has more opportunity to change the capital structure than does a minority investor. The difference becomes apparent when one values a particular stream of operating cash flows by developing a weighted average cost of capital (or WACC). The WACC requires three primary inputs, the cost of equity, the cost of debt, and the proportion of equity to debt. A strategic acquirer could use as the starting point their WACC, which is based on their costs of debt and equity. This can be considerably lower than the target company's. Additionally, the acquirer may increase the proportion of debt in a subject company. This can result in higher valuations.

A minority investor, on the other hand, can only consider the existing company's cost of debt and equity. Additionally, this investor cannot change the capital structure.

Selecting Valuation Measures Based on the Company Itself. In addition to considering the level of value, selecting the measures that produce the most accurate opinion of value can often depend upon the company itself. Is the company capital intensive? Is it over or under-leveraged? Is it development stage? Is it reinvesting heavily to fund more rapid growth? Importantly, is it any of these things relative to its peers? What if a company is development stage? In general, developing companies generate sales first, then gross profits, operating profits, and net income, and maybe only then net cash flow. If a company is a new entrant to a relatively mature industry, it may have value based on strong sales or gross profits even though it has not yet generated net income. The assumption here, of course, is that one day it will have profits and margins similar to that of other more established companies. The idea is that a dollar of its sales will be worth an amount equivalent to a dollar of sales of another company. While such an approach can produced an indicator of value, it is important to realize that he value will only be accurate if, ultimately, the subject company does produce the anticipated profits.

Industry Valuation Measures. Many industries have favorite rules of thumb and valuation measures that stray far from net income or net cash flow. Examples include: price per population unit for wireless communication companies, price to funds from operations for real estate investment trusts, a multiple of annual gallons sold for a heating oil distributor, etc. All of these seek to describe the value of some kind of activity in an industry that has unique meaning.

Beauty is in the eye of the beholder. A control-based strategic buyer with an existing platform in a particular industry may find more meaning in these valuation measures than in any other. A financial buyer seeking a controlling interest would consider these valuation measure sin the context of their ability to create cash flow needed to finance the capital structure. A minority investor can really only rely on these measures to the extent that they believe a company will be subject to acquisition by a strategic buyer. While the above methods are useful in examining value, they are better used as a check on the reasonableness of other approaches to value.

Conclusion. There are many measures to use in valuing a business. While the best indication of value is often based on earnings or cash flow, all relevant approaches and measures should be considered.
VMI Highlights & Acquisition Opportunities

Highlights

* Our senior analyst, Joseph M. Egler, CFA, appeared on “Mondschein Talks Divorce” for the fourth time on March 22, 2003. John Mondschein, Esq., the host of the show believes that “Mondschein Talks Divorce” is the only divorce related talk show on the radio. It can be heard on WGPA 1100 AM from 1:00 PM to 2:00 PM in the beautiful Lehigh Valley.
* Ed Wilusz, ASA, CFA, will make two presentations at business valuation seminars for Family Law Attorneys. The first session will be in May and is titled “An Overview of Accepted Business Valuation Methods & Procedures, The Income Approach to Valuation.” The second will be in October and is titled “Discounts and Premiums in the Valuation Process.”

Acquisition Opportunities

* Turnkey plastics recycler located in the Tri-state area. With sales of $6 to $7 million, the total owner/operator’s return approximates $1 million.
* Well-established mechanical services business located in PA (plumbing and HVAC services primarily to builders for new and renovation residential construction). With 2002 revenue of $5.5 to $6.0 million, the Company’s EBITDA is in the 10% range.
* Service related business with approximately $3 million in pre-tax income.
* Fast growing supplier of a branded consumer product with profit in $4 million to $5 million range.

Please call Andrew Wilusz, ASA, Director of Mergers & Acquisitions at 215-598-9310 if you or your clients have an interest in the above companies.

Value Management Inc.
758 Durham Road
Newtown, PA 18940

Telephone: (215) 598-9310
Fax: (215) 598-0589
E-mail: info@valuemanagementinc.com