Value Management Inc.

The Business Valuation Specialist

SUMMER 2015

Issues & Updates

In This Issue

Pressure Grows on Stand-Alone PE Firms Regarding Independent Valuations

Many stand-alone private equity managers are wondering whether they will be required to use independent valuation firms for determining the value of holdings, according to a memorandum from Willkie Farr & Gallagher LLP. Investment managers who handle publicly traded companies are now generally using independent firms to help with valuations, but neither U.S. GAAP nor industry guidelines require it.

More scrutiny: PE valuations have come under increasing review by both investors and regulators, according to the memo, for the following reasons:

- More frequent fundraising cycles, requiring the presentation of interim performance data and IRR of "active" funds;
- Continued focus on valuation practices in SEC examinations conducted by the Office of Compliance Inspections and Examinations (OCIE);
- Prevalence of sponsor-to-sponsor sales of portfolio companies, which can highlight the variance in valuations; and
- Institutional investors continuing to have exposure to portfolio companies through more than one private equity firm and seeking consistency across their various managers.

PE fund managers who use independent valuation firms typically have them assist with the valuation of Level III assets (assets for which pricing inputs are unobservable and there may be little, if any, market activity), says the memo. They're also engaged to support Sarbanes-Oxley compliance and demonstrate that there are strong internal controls.

Extra: The AICPA has a task force working on a practice aid that focuses on valuing holdings of PE and venture capital funds. Look for a draft later this year.

VMI Highlights

Value Management Inc. will sponsor the Philadelphia Estate Planning Council luncheon on September 16th at the Union League of Philadelphia. The topic is "Planning for an Aging Population – Your Clients, Your Parents and Someday You!" The speaker is Bernard A. Krooks.

Value Management Inc. is a sponsor at the 20th Annual Multi-State ESOP Association Conference held at the Mohegan Sun Resort in Wilkes Barre, PA. Greg Kniesel, ASA, presents on September 17th. His topic is "ESOP Financing and Market Update." Ed Wilusz, ASA, CFA, Managing Director, presents on September 18th. The topic is "Have an ESOP Your Employees Can Be Proud Of."

Andrew Wilusz, ASA, will be presenting to the Estate Planning Council of Cumberland County. His topic is "Business Succession and/or Sale: Planning for Success."

If you are interested in having one of our analysts give a business valuation/merger & acquisition related presentation to your firm or at a conference, please contact Susan Wilusz at smw@valuemanagementinc.com or at 215.343.0500.

Office Address:
2370 York Road, E2 • Jamison, PA 18929-1031
(215) 343-0500
www.valuemanagementinc.com

Inside the Mind of the IRS Re: Reasonable Compensation

Taxpayers and valuation analysts can now get a rare look at how the IRS examines reasonable compensation cases. The agency recently made public an internal document, "Reasonable Compensation: Job Aid for IRS Valuation Professionals," which has a wealth of information to help valuators anticipate the challenges the IRS will make to reasonable compensation estimates.

Treasure trove: The job aid, which includes a number of appendices, examines valuation approaches, compensation data sources, suggested reading material, and court cases that shape the IRS's current thinking on this matter. It also discusses taxpayer arguments for levels of compensation that may appear to be unreasonable. For example, one argument for a high level of compensation is that an individual was underpaid in prior years. The job aid provides questions the IRS agent will ask when assessing that argument and also the relevant court cases on that specific issue. You'll also find sample information document requests (IDRs), examples of the market and income approaches, and much more.

IRS S Corp Job Aid Now Available

An internal IRS document is now available that reveals the agency's most current thinking on the valuation of S corps, one of the hottest topics in business valuation. The document was written to help IRS professionals who are examining S corp valuations—and it presents a wealth of information for valuation analysts. The 33-page job aid is entitled *The IRS Valuation of Non-Controlling Interests in Business Entities Electing to Be Treated as S Corporations for Federal Tax Purposes.*

Another non-IRS book, *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle,* by Nancy J. Fannon and Keith Sellers, challenges traditional notions about the differences in value between a pass-through entity and the public-market C corporation. This book presents over 60 academic studies and papers that shows that shareholder-level taxes do indeed affect a firm's value. Up to now, the IRS and the Tax Court have refuted this position, largely because data have never been presented to support it.

Court Uses Hypothetical License to Determine Royalty Damages Against USPS

In 2002, the U.S. Postal Service issued a 37-cent stamp of a photograph of the Korean War memorial. It paid the photographer $1,500 for the use of the photograph. In 2006, the memorial's sculptor, Frank Gaylord, sued the government for infringing his copyright. But the government and the court rejected the sculptor's claim, saying the stamp constituted fair use of his work. The sculptor appealed.

Postage due: After five years and multiple decisions and remands, the appeals court ruled that the sculptor should be paid a royalty based on a hypothetical license for his work and not what the USPS usually pays for the use of an image on a stamp. The lower court considered stamps used to send mail, commercial merchandise featuring an image of the stamp, and unused stamps purchased by collectors. The lower court said the USPS made at least $5.4 million in revenue from the sale of stamps to collectors, which was almost pure profit, and awarded Gaylord 10% of the revenue, or $540,000—plus interest.

The 10% was based on what the sculptor normally charges to license his work. The appellate court said it would be reasonable for the trial court to conclude that the USPS had sufficient incentive to agree to that royalty rate for sales of collector stamps.

The case is *Gaylord v. United States*, Case No. 14-5020 (Fed. Cir., Feb. 4, 2015) (Taranto, J).

Most Family Businesses See Steady Growth Ahead: PwC Survey

Almost three-quarters of family businesses around the world expect to see steady growth ahead, a new survey from PricewaterhouseCoopers reveals. Two-thirds (65%) of family businesses reported growth in the last 12 months, and 15% are aiming to grow aggressively over the next five years. "This year's research tells us that the family business segment remains resilient and dynamic even though the post-recession economic environment is proving tough and there are continuing pressures in relation to skills shortages, innovation, and governance," says PwC. The survey results come from a poll of 2,400 owners and managers in 40 different countries.

Financial Experts Spar Over 'Market Efficiency' in Groupon Litigation

In re Groupon Securities Litigation, 2015 U.S. Dist. LEXIS 27334 (March 5, 2015)

The market efficiency theory has sparked a lively debate among financial experts and plays a critical role in securities fraud litigation. A *Daubert* ruling in the *Groupon* class action suit discusses what's required to show a company's stock traded in an efficient market.

Bad deal: Groupon, the deal-of-the-day company, went public in November 2011. Investors subsequently sued under Section 10(b) of the Exchange Act and Rule 10b-5, alleging harm from the company's misrepresentations. Under the efficient market hypothesis—increasingly under attack by economists—the market price of a company's stock embodies all public information about the company. In litigation, this means investors do not have to show direct reliance on the misstatements but can proceed on the automatic assumption that significant misstatements caused share prices to fall.

Detractors argue that many investors do not rely on the integrity of the market at all. What an investor is willing to pay for a company depends on a host of other factors (and may not reflect the value of a company at all.

Unexpected earnings news: Here, the investors retained an experienced expert who performed an event study to show cause and effect between unexpected company events and movement in the stock price. He said he looked for "big news days" during the relevant period by identifying significant, unexpected earnings-related news. He concluded that only two dates met his objective criteria. Admittedly this was a low number, he said, but one that was not uncommon for a class period that was only seven weeks. Further, he used a one-year period to control for standard volatility. However, changing the length of the control period would not affect the results, he said. He concluded that Groupon's stock traded in an efficient market.

The defendants' expert attacked the study on numerous grounds, but his criticisms had no traction with the court. The investors' expert "correctly analyzed 'market efficiency' from the perspective of whether unexpected information quickly affected Groupon stock price—not whether the price of Groupon stock accurately reflected all information," the court determined. Although the defendants' expert was "clearly an expert in efficient capital markets," he failed to understand that the law did not require a perfectly efficient market to show fraud on the market.

Takeaway: Courts are reluctant to adopt the changing view on market efficiency coming from the academic community. Debates "about the degree to which the market price … reflects public information about the company" are "largely besides the point" in terms of determining market efficiency under legal precedent, the court in this case said.

Delaware Chancery Grapples With Sale Price Versus Post-Merger DCF

In re Ancestry, 2015 Del. Ch. LEXIS 21 (Jan. 30, 2015)

What's more plausible: the merger price or the value derived from the discounted cash flow? This was the overarching question the Delaware Court of Chancery recently explored in a statutory appraisal action.

Backstory. Ancestry.com was a self-described "pioneer and the leader in the online family research market." The company went public in 2009, when its shares traded at $13.50 each. After it became the sponsor of a popular NBC show, "Who Do You Think You Are?*"* the price per share rose as high as $40. But its fortunes changed again, and its board decided to sell the company to a private equity investor for $32 per share. The merger price represented a 41% premium on the unaffected trading price of company stock. Ninety-nine percent of the voting shares approved of the transaction, but the dissenters asked the court for a fair value determination.

Both sides retained experts who agreed on the use of the DCF analysis but disagreed over key inputs. According to the Chancery, the petitioners' expert "proved something of a moving target" in that he proposed at different points in the litigation that the company was worth as much as $47 per share and no less than $42.81. The company's expert concluded the stock was only worth $30.63 per share. That price was actually below the value the buyer, a nonstrategic investor, was willing to pay, the court observed.

'Riffs on market price': Both experts were respected and well qualified, but their valuations were "less than fully persuasive," the Chancery noted. The analyses were "result-oriented riffs on the market price." By his own account, the petitioners' expert "tortured the numbers until they confess[ed]." The company's expert "candidly suggested" that if his valuation had been as far from the merger price as that of the petitioners' expert, he "would have tried to find out a way to reconcile those two numbers."

Continued on next page...

The Chancery said these statements showed the limited use of a post hoc DCF valuation. "If an analysis, relied upon to assess whether a sales price presents the fair value, in turn uses that very sales price as a check on its own plausibility, and if it must be revised if it fails that check, then the process itself approaches tautology."

Instead of relying on either expert's analysis completely, the court performed its own DCF, arriving at a value of $31.79 per share. But, since the sales process was "reasonable, wide-ranging and produced a motivated buyer," the court decided it would be "hubristic" to elevate its DCF estimate of value over the value an entity "for which investment represents a real—not merely an academic—risk" placed on the company. Therefore, the Chancery found the $32 merger price best represented the fair value of company stock. The DCF value was useful as a check on the market-derived valuation, the court said.

Goodwill Valuation for Law Firms

When valuing a law firm, how do you put a price on a lawyer's reputation? An earnings multiplier is a common method for goodwill valuation, according to experts in law firm valuation. "Goodwill, if there is value in it, flows from the ability of the seller to successfully transfer a book of business to the buyer," says **Dale Lash**, partner-in-charge of RubinBrown's Business Valuation Services Group in Denver. Lash is quoted in an article in the March 2015 issue of the *ABA Journal.*

Current range: Common factors for a solo practitioner's earnings multiplier calculations include earnings history, geographic location, the practice's marketing plan, and the seller's competition. "Each practice is unique, just like each lawyer," says **Ed Poll,** author of *Selling Your Law Practice: The Profitable Exit Strategy*. "That being said, a general rule of thumb for a standardized multiple range is one-half to three times the gross revenues."

ABOUT VALUE MANAGEMENT INC. VMI is a financial consulting firm specializing in valuing businesses, corporate securities and professional practices. Our firm is built on the performance of more than 6,500 valuations. Appraisals are rendered for estate tax planning, litigation support, and many other situations requiring independent appraisal. Our newsletter is published quarterly and does not constitute legal or financial consulting advice. It is offered as an information service to **VMI's** clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries on specific valuation matters are welcomed.

Value Management Inc. The Business Valuation Specialist

2370 York Road, E2 • Jamison, PA • 18929-1031

Address Service Requested

PRSRT FIRST CLASS
U.S. POSTAGE
PAID
HAVERTOWN, PA
PERMIT # 45