VALUE MANAGEMENT INC.

Investment Banking + Advisory Services

ISSUES + UPDATES

FALL 2019

Newest Survey on Private Rates of Return

For the "2019 Private Capital Markets Report," researchers at the Pepperdine University Graziadio Business School asked private capital market players what returns they project. The players are divided into six segments aligned with the major institutional arms of the private investment world, each with different return, investment, and research characteristics. The project was originally launched in 2007. The median cost of capital rates determined by the latest survey appear in the table below. The full report contains much more detail on each type of funding.

Type of Private Capital Funding	Pepperdine Median Rate of Return (Range)
Banks	5.0%-6.3%
Asset-based lenders	4.0%-15.0%
Mezzanine financers	13.0%-15.0%
Private equity groups	21.0%-37.0%
Venture capital investors	28.0%-38.0%
Angel investors	28.0%-38.0%

In This Issue:

Acquisitions of Private Firms Up 12% in 2018

The number of announced acquisitions of privately owned companies increased from 7,793 in 2017 to 8,761 in 2018 (a 12% increase), reveals the 2019 Mergerstat Review. The purchase of privately held companies is a significant component of merger and acquisition activity, the report points out.

Acquisitions of Privately Owned Companies 2009-2018

	Number of Acquisitions	% of Acquisition Activity	Total Dollar Value Offered (Millions)
2009	4,483	43%	81,087.2
2010	5,997	57%	145,799.8
2011	6,607	63%	285,112.3
2012	6,677	63%	235,703.8
2013	6,232	59%	188,856.1
2014	8,156	77%	362,167.2
2015	8,792	83%	334,861.5
2016	8,315	79%	385,652.9
2017	7,793	74%	378,425.4
2018	8,761	83%	339,182.8

(Source: *FactSet Mergerstat Review 2019*)

(continued on page 2)

VMI Highlights:

Greg Kniesel will be speaking at the ESOP Association's Multi-State Conference. His topic is, "He Said, She Said: A Valuation Hot Topics Debate." He will also be speaking at the ESOP Association's Las Vegas Conference and Trade Show. His topic is, "The Basics of Valuation."

Andrew Wilusz will be speaking at the PBI's 26th Annual Estate Law Institute in Philadelphia. His topic is, "Family Business: Planning for a Successful Sale or Succession." Ed Wilusz will also be speaking. His topic is, "Business Valuation for Estate Planning."

Ed Wilusz will be speaking at the ESOP Association's Multi-State Conference. His topic is, "Explaining the Stock Price to Your Participants."

(Continued from page 1)

Key drivers: Private firms are being acquired for several reasons. The owner lacks an heir to take over the business and, nearing retirement, needs to sell to achieve liquidity for investment diversification and estate tax purposes. Another common reason for sale is growing pains. Increasing demand for the company's products or services puts pressure on the firm to become more sophisticated and efficient in its operations. To fulfill these demands, the owner/entrepreneur sells the business to obtain needed financial resources for expansion.

Senior Healthcare M&A Soars

The number of publicly announced senior housing and care acquisitions in the fourth quarter of 2018 topped 100 transactions for the third quarter in a row, with 103 total transactions announced. The fourth-quarter acquisition volume helped propel 2018 into the record books with 426 publicly announced acquisitions in the senior housing and care sectors. The activity continues to be almost evenly split between skilled nursing and senior housing.

Private Equity Acquisitions in the Physician Practice Space

A recent article in Middle Market Growth states that private equity (PE) firms continue to flock to physician-run practices. This is a fragmented space where demographic and technological trends are converging, and one where sellers' expectations can make a deal vulnerable to failure if not managed properly.

Buying physician practices and consolidating them into larger platforms has been a private equity strategy for two decades, but in the last several years, PE involvement has extended to a wide-range of specialty areas including dermatology, ophthalmology, orthopedics and oncology, among others.

The physician practice management, or PPM, space appeals to PE investors looking to build regional or national businesses through add-on acquisitions. PE firms can help with marketing initiatives and brand awareness, and by reducing operating costs through back-office improvements and enhance technological capabilities. A larger organization may also have greater leverage with payers.

Dentistry was the specialty that reinvigorated interest in PPM investing about seven years ago. Dental practices have a retail-centric model, one that's easy to understand. It typically involves fewer government payers and less insurance involvement compared with many health care specialties, yielding a less complex revenue stream. Dentistry was also an attractive market to enter because of its fragmented nature. Despite the M&A activity in dentistry, only 7.4 percent of U.S. dentists were affiliated with a dental support organization as of 2017, according to the American Dental Association.

Dermatology is another medical specialty where investors have been active. It's one with a mismatch of supply and demand. There is a nationwide shortage of dermatologists, even as higher rates of skin cancer and other diseases have increased demand for services. Successful dermatology investments have led investors into other specialties.

As baby boomers age, the need for hip replacements, spinal surgery and other services has grown. That trend, coupled with technological advancements that enable more outpatient procedures, has spurred demand in the orthopedic space - and PE investment has followed.

Buyer enthusiasm has driven up prices. For larger businesses, valuation multiples have been in the 11x to 14x EBITDA range. While everyone expects the prices to come down, they continue to remain high.

Sellers' Perspective

Fortunately for PE firms eyeing medical practices, many physicians are willing to sell, for reasons ranging from demographic shifts to changing industry dynamics. One driver is succession planning for practitioners nearing retirement. Changes in the health care industry are also playing a role, as increased reimbursement pressure and competition from larger providers have made it difficult to maintain an independent practice.

While innovation in health care has created opportunities for some practices, it has disrupted others. For example, the impact of Invisalign on orthodontics. Unlike braces, a dentist can provide the teeth-straightening devices - a trained orthodontist isn't required. Such a threat to a practice's core scope might prompt a physician to consider an alternative career path.

After a sale, a physician often becomes an employee of the new PE-owned business, and setting expectations up front is critical for a PPM acquisition to succeed. Sellers need to consider how much of their current earnings stem from being a practicing physician versus being the owner of a practice - and to compare those figures with the proceeds from the sale and their future salary as an employee. They should also consider how much they value their social status. They're going from a partner in an important practice in the community to an employee in a big corporate practice group.

Health Care M&A

Health care deals represented 12 percent of global M&A volume in 2018, second only to technology, according to JPMorgan Chase.

In its 2018 Year in Review report, Bain cited notable health care deals announced last year. They included Amazon's purchase of online pharmacy PillPack; Roche's acquisition of Flatiron, a software provider for electronic health records related to oncology; Medtronic's purchase of Mazor Robotics, a maker of a robotic system for spinal surgery; and Cigna's acquisition of pharmacy benefits manager Express Scripts.

There were 186 IPOs of health care companies globally in 2018. While slightly fewer in number than the 190 IPOs of 2017, the offerings in 2018 earned $24.08 billion -over $9 billion more than the year prior, according to S&P Global Market Intelligence.

Deal value is on the rise in the digital health space, made up of companies that build hardware and software solutions to help individuals track their health and communicate with health care providers. In 2018, $5.9 billion was invested across 24 digital health deals - a sharp increase from the $3.5 billion in deal value in 2017, according to PitchBook.

Since the beginning of 2010, 23 private equity firms have recapitalized physical therapy practices, according to a report from PE firm Provident Healthcare Partners. For nearly half of those practices, the PE investments were the first time the practices have received institutional capital.

Companies creating technology to address women's health care issues - a space known as femtech - attracted barely $100 million in venture capital funding five years ago. In 2018, that figure had increased nearly four-fold to $392 million, according to PitchBook.

Court Chooses DCF to Determine Fair Value in 'Straightforward' Appraisal Case

Kendall Hoyd & Silver v. Trussway Holdings, 2019 Del. Ch. LEXIS 72, 2019 WL 994048 **(Feb. 28, 2019)**

Several standard valuation methods were in play in a statutory appraisal case arising out of the minority shareholder's petition to the Delaware Court of Chancery for a fair value determination. Neither the aborted sales process nor the market approach produced reliable indicators of fair value, the court found. Instead, it relied on a discounted cash flow (DCF) analysis and, in so doing, discussed and resolved disagreements between the parties' experts over various inputs, including management projections, beta, and residual value. As the subject company was not a public company, the Delaware Supreme Court's Dell and DFC Global decisions did not guide the Court of Chancery's analysis.

Nine-year projections. The dispute related to the conversion of a corporation into a limited liability company. Trussway Holdings Inc. (Trussway) had a wholly owned subsidiary, Trussway Industries Inc. (TII), that was the leading manufacturer of prefabricated trusses and other components for the multifamily housing market. TII was the company whose value was in dispute. It had six manufacturing facilities in the U.S. and approximately 930 employees.

In mid-2016, TII contemplated a sale and hired an investment firm to develop a valuation of the company. The financial adviser came up with a value range of $202 million to $298 million. It contacted over 75 parties. At the end of 2016, TII made presentations to seven interested parties. The focal point was nine-year projections (2017 to 2025). The projections envisioned revenue for 2016 to be $218.2 million, increasing in 2017 to $235.9 million. Afterward, revenue was expected to grow from 2.2% to 14.9% annually through 2025. These numbers were very optimistic compared to the numbers appearing in internal management projections for 2015 and 2016. For example, the 2015 projections anticipated an increase from $196 million in 2015 to $204 million in 2016 and an annual decline thereafter, to $132.76 in 2019. The record showed one board member foresaw declines in multifamily housing starts. Internal five-year projections for 2016 also anticipated a decline in revenue through 2020.

A company representative said in his deposition that the nine-year projections were adjusted downward during the sales process "because the business wasn't performing as was anticipated."

Importantly, the nine-year projections added to the base case projected costs, revenue, and EBITDA related to four strategic initiatives. The effect was an increase in revenue and EBITDA. By 2025, the initiatives accounted for 39% of revenue and 43% of EBITDA over the projected nine years.

In December 2016, Trussway's board of directors approved a merger that transformed Trussway and its subsidiaries, including TII, into LLCs. The transaction was driven by one majority shareholder that owned about 95% of the company's stock. Two minority shareholders held roughly 5% of the company's stock and did not vote on or consent to the merger. Instead, the minority shareholders filed for statutory appraisal under section 262 of the Delaware appraisal statute.

While the merger went forward, the negotiations over the sale of TII were ongoing. In February 2017, one offer emerged. The bidder offered $170 million. It later withdrew the offer, and the sale went nowhere.

The parties agreed to the value of the corporate assets and liabilities but did not agree on the value of TII. Ultimately, one minority shareholder settled in principle with Trussway (the respondent). The other shareholder's petition went to trial in the Delaware Court of Chancery.

Both the petitioner and the respondent offered expert valuation testimony.

Applicable law. Section 262 of the Delaware appraisal statute entitles dissenting shareholders to petition the Delaware Court of Chancery for a determination of the fair value (intrinsic value) of their shares as of the merger date. The fair value determination must exclude "any element of value arising from the accomplishment or expectation of the merger." The court "should first envisage the entire pre-merger company as a 'going concern,' as a standalone entity and assess its value as such." Under the statute, the court must undertake a case-by-case analysis that considers "all relevant factors." Both parties have the burden of proving their valuation positions.

Court rejects market approach. In a nutshell, the petitioner's expert determined the petitioner's interest in Trussway was $387.82 per share, which was made up of the value of TII, plus the agreed-upon value of the corporate assets, minus the agreed-upon amount of liabilities.

The company's expert (respondent's expert) arrived at a fair value of $225.92 per share.

The petitioner's expert performed a discounted cash flow (DCF) analysis to which he assigned 60% of the weight, a comparable companies analysis that he weighted at 30%, and a precedent transactions analysis that he weighted at 10%.

The company's expert relied on the results of two DCF analyses. One analysis was based on the nine-year management projections. In a second analysis, the expert modified the nine-year projections to become five-year projections. He assigned a 25% weight to the DCF using the nine-year projections and a 75% weight to the DCF based on the five-year projections.

Neither party claimed that the unsuccessful sales process revealed a value that represented fair value. The court said the one bid emerging during the sales process, $170 million, and other indications of interest, at best, served as "a very rough reasonable check."

The court agreed with the company's expert that the petitioner expert's comparable companies analysis did not generate a meaningful value indicator because the companies used as comparables were insufficiently similar to the subject company in regard to size, public status, and products. The company further contended that the court should disregard the result of the opposing expert's precedent transaction analysis since that analysis was based on only one reliable transaction. The court agreed and used the DCF for its determination of fair value.

DCF disagreements. Here, the experts used a similar methodology to perform their DCFs but had consequential disagreements over a few key inputs, the court noted.

Projections. The issue was the reliability of management's nine-year projections. The petitioner's expert used them in their entirety, finding they were based on "the best currently available estimates and judgments of the management of the company."

The company argued that a valuation should use only the base projections, thus ignoring the strategic initiatives. Alternatively, if the strategic initiatives were part of the analysis, the valuation should assign greater weight to the first five years of company projections, as the company's expert had done.

In discussing the reliability of the nine-year projections, the court noted the company "routinely" created projections. The projections were done in the course of business and, in this instance, the company intended to use them in the context of a sale, the court observed. Sale considerations generated optimistic projections, the court noted. It also found the projections were longer than the common five-year projections. One explanation for the extended period was that the multifamily housing industry was cyclical. The longer projections aimed to correct "cyclic distortion," the petitioner argued.

The court agreed that the projections were "the best predictor" of the subsidiary's performance. Moreover, it found that the strategic initiatives were part of TII's "operative reality" and should be considered in valuing the company as a going concern. "TII had the unilateral choice to pursue the initiatives, and projected that they would do so," the court noted.

The court acknowledged there was "a degree of huckster's optimism in these predictions" and noted that the petitioner's expert seemed to acknowledge as much by adding a 1% risk premium to account for the uncertainty surrounding the forecasts. However, there was no basis for the 1% risk premium adjustment, the court found. It adopted a modified version of the approach the company's expert took regarding the projections. The court weighted the results of the two DCF-generated values equally. One value resulted from using the nine-year projections and the other from using the same projections but beginning the terminal period after five years. The court said its analyses applied the calculation the company's expert made from the nine-year projections of management's projected annual cash flows and expected debt and equity levels.

Residual value. To calculate the terminal value, both experts used the Gordon growth model. However, the plaintiff's expert also used an EBITDA exit multiple of 7x, which the opposing expert said doing so improperly increased the residual value. The company's expert used a 2.3% growth rate, which the petitioner claimed was too low.

The court said use of the exit multiples approach with its high-growth-rate assumptions was inappropriate considering the court already used the optimistic nine-year forecast. Therefore, the court decided to use the Gordon growth model and a 2.3% growth rate.

The court's inputs generated two values. A DCF analysis based on the nine-year forecast resulted in a value for TII of $197.8 million. A DCF analysis based on the first five years of the projections resulted in a valuation of $168.8 million. Weighting each result equally, the value of the company was about $183.3 million. Adding the other agreed-upon values for assets and subtracting liabilities results in an equity value of $143.3 million or a per-share value for Trussway Holdings of $236.52—thus a value close to the fair value calculated by the company's expert.

Recent Daubert Rulings Show Courts' Different Takes on the Role of Gatekeeper

A series of recent *Daubert* cases illustrate how different courts may interpret the role of "gatekeeper," which they perform under Rule 702 and *Daubert*, differently. In assessing the admissibility of expert testimony, some

(continued on page 5)

(Continued from page 4)

courts believe the law requires them to be inclusive while others believe close scrutiny of the expert's qualifications and the reliability of his or her testimony is warranted.

Rule 702 of the Federal Rules of Evidence allows a qualified expert to testify if his or her specialized knowledge would assist the trier of fact and the testimony is based on sufficient facts and reliable methods properly applied to the facts. Under *Daubert*, the evidence must be relevant and reliable.

Ferraro v. Convercent, a contract and tort case revolving around a company that provided software-based services, falls into the first category. The defendants claimed the plaintiff's expert was unqualified because he lacked the necessary experience valuing that type of company, but the court found the applicable law did not require this degree of specialized knowledge. However, *Weinman v. Crowley*, a bankruptcy case turning on insolvency, is definitely on the other end of the spectrum. The Bankruptcy Court, on its own accord, examined the insolvency expert's qualifications and found them wanting, notwithstanding the expert's experience in international finance. Also, in *Ferraro*, the court said some degree of speculation is common in expert testimony. In contrast, in *Cargotec v. Logan Industries*, a Texas appeals court found the damages testimony was inadmissible because the expert relied on management projections that were based on some unfounded assumptions, notwithstanding the expert's independent work on the case.

The takeaway is that, while valuators and attorneys should study a lot of *Daubert* cases for a particular court's take on Rule 702 and Daubert, courts have a lot of leeway in how they come out on admissibility.

It's Not Just the Economy, Stupid!

Company Specifics are Key for Buyers when Valuing a Business

The state of the economy is an important consideration for anyone buying a business. Stock market performance, interest rates, the availability of funding, and the prospect of growth or recession in the local, national and global economies weigh heavily on decisions to buy. However, when it comes to determining how much to pay, buyers focus on several company-specific characteristics as the building blocks for value. Key components considered by buyers when valuing a business typically include:

- Revenue Trends
- Customers & Concentrations
- Management & Employees
- Competitive Advantages & Industry
- Profit Margins
- EBITDA

While buyers do use revenue as a basis for determining value with certain businesses (such as with software as a service or "SaaS" providers), profitability is typically the foundation of buyer pricing for most companies. Accordingly, pricing is often presented in terms of a multiple of EBITDA (earnings before interest, taxes, depreciation, & amortization), one of the commonly considered measures of corporate profitability. The size of the valuation multiple selected is based on the level and quality of earnings and on the buyer's assessment of other critical, company-specific characteristics.

Revenue Trends

Higher revenue growth impacts pricing favorably. Companies qualifying for the highest valuation multiples typically demonstrate consistent, higher-than-average growth. Buyers will look at recent trends (last three years), focus on the last twelve months of performance, and seek evidence to support the sustainability of revenue growth. Examining the composition of a company's revenue helps address sustainability and growth potential. How many sources of revenue are there (by product, service and/or customer), what percent does each source contribute to total revenue, does this change, and why? Are there any contracts that guarantee a certain revenue level, and if not, what does? Are recent spikes in revenue due to one-time events?

Customers & Concentrations

A large, high-quality customer base with low customer concentration adds to value. Buyers believe "the more customers, the better" and that a high or growing market share can add value. Buyers prefer customers/customer bases that are: reliable sources of revenue, good payers, well-known, diverse, and are growing. Buyers scrutinize customer concentrations and usually review a breakdown of annual revenue by customer for the last three years. The more that revenue is concentrated with a low number of customers, there is higher risk perceived by buyers. The possibility of a significant drop in revenue stemming from changes with top customers can lead to a lower multiple. Customer concentrations are not necessarily damning but need to be examined and understood so that buyers can appropriately factor them into pricing. Having favorable or long-term customer contracts, exclusive rights or being the customer's only provider, among other things, can mitigate the risk of customer concentrations.

Management & Employees

An experienced, comprehensive management team with a shared vision of company oversight and an established, content workforce that has good relations with management can increase value. Buyers value delegation of duties and examine closely for over-reliance on key individuals. Like the risk concerns associated with customer concentrations, buyers can view dependence on key people as a negative and possibly detracting from value.

Competitive Advantages & Industry

Having competitive advantages which lead to out-performing industry peers or to preventing competitors from encroaching can increase value. If the company being priced is in a mature industry with many competitors and has no discernable advantages over competitors, a pricing premium would not be justified and perhaps a decrease to the valuation multiple is warranted. The industry itself can influence the range of multiples typically applied; that is, companies in some industries are valued at higher multiples than those in other industries (which is why a manufacturer is unlikely to get the same multiple as a software company, even if they have the same revenue and profitability).

Profit Margins

Better margins lead to higher valuation multiples. Value is determined using absolute and relative performance metrics. In determining any given company's value, a multiple will be applied to a company's actual EBITDA (its absolute performance). However, the determination of the valuation multiple often includes a comparison of the company's performance relative to the profits and expense margins experienced by others involved in similar businesses. The company with $10 million EBITDA is likely more valuable than a similar company with $5 million EBITDA, but if the smaller company has a higher profit margin ($5 million = 15% of revenue vs. $10 million = 10% of revenue),it may be valued using a similar or higher multiple than the larger company.

EBITDA

Larger companies are generally valued with higher multiples of EBITDA than smaller companies. In the GF Data M&A Report for August 2019 which details private equity-backed acquisitions, it shows that transactions involving larger companies (based on total enterprise value or "TEV") were valued with higher average multiples.

TEV ($ Millions)	TEV/EBITDA Multiple
$10 - $25	6.4x
$25 - $50	7.1x
$50 - $100	7.2x
$100 - $250	9.3x

SUMMARY

While size can impact value, it should be clear that size is certainly not the only thing that matters in determining a multiple of EBITDA for valuing a business. There is no doubt about the importance to buyers to quantifying as much as possible when determining a purchase price. It is essential to remember that qualifying key, company-specific components is an essential part of buyer pricing.

ABOUT VALUE MANAGEMENT INC. VMI is an Investment Banking and Advisory services firm. VMI helps businesses assess, understand and realize their value. 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 transaction matters are welcomed.

Address Service Requested

2370 York Road, E2 | Jamison, PA 18929

VALUE MANAGEMENT INC.
Investment Banking + Advisory Services