VALUE MANAGEMENT INC.

Investment Banking + Advisory Services

ISSUES + UPDATES SPRING 2018

Middle-Market M&A Strengthens in 2018

The heightened private equity investing, increasing valuations and a growing number of deals involving foreign buyers are likely to drive U.S. middle-market activity higher in 2018 according to an article in "Middle Market Growth," a publication of the Association for Corporate Growth.

Stronger M&A activity in the middlemarket arena this year would build on the positive momentum recorded in 2017. Middle-market companies - institutions with annual revenue ranging from $10 million to $1 billion - were targets in announced deals totaling $100 billion. That represents a 14 percent increase from the levels seen in 2016 and marks the highest aggregate value for middle-market deals since 2014, according to S&P Global Market Intelligence data.

Middle-market M&A activity in 2017 was bolstered by strength in the technology space, which led all sectors in both the number of deals and total deal value, generating 90 transactions with nearly $22 billion in aggregate value.

Private equity firms also helped drive middle-market M&A activity higher in 2017. Leveraged buyout activity in the middle-market space rose to $8.9 billion in 2017 from $6.7 billion a year earlier. The level of activity last year marked the highest disclosed dollar amount for middle-market leveraged buyouts since 2013, when $10.5 billion in transactions occurred.

Private equity interest in middle-market companies seems unlikely to wane in 2018, with firms holding in excess of $1 trillion of so-called dry powder, or capital raised but not yet deployed.

Traditional strategic buyers should support further M&A activity in the middle-market arena as well, as cash in corporate America stands at extraordinary levels. Calculations place total cash and investment holdings among nonfinancial and real estate S&P

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VMI Highlights:

Ed Wilusz was a panelist at the PA/DE Spring ESOP Conference held on March 29th in Glen Mills, PA. The panel's topic was "Impact of New Tax Reform on ESOPs."

Ed Wilusz and Greg Kniesel will both be speaking at the National Center for Employee Ownership's Annual Conference held in Atlanta, GA from April 18 through 20.

VMI will be a sponsor at the Union League Business Expo on April 17. Please contact Susan Wilusz at smw@valuemanagementinc.com or 215.343.0500 if you would like to attend.

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500 companies at more than $2 trillion. The passage of tax reform should cause that number to increase even further as companies receive a windfall of profits from the corporate tax rate falling to 21 percent from 35 percent.

As middle-market M&A moves ahead in 2018, it's anticipated valuations may edge higher. While many economists believe the current U.S. economic cycle could be entering the late stages, U.S. corporate profits just recently reached a record level of $1.86 trillion in the third quarter of 2017, according to the Federal Reserve Bank of St. Louis. The surplus of cash and the current phase of the economic cycle could increase buyers' willingness to bid assets higher. Borrowing costs have begun to rise and that could potentially deter some buyers, but steady increases in interest rates last year failed to cool activity or hinder valuations.

Intangibles Make Up 75% of Purchase Price Allocations

Three-quarters of total asset value in purchase price allocations (PPAs) for 2016 transactions related to intangibles, according to the "2017 Purchase Price Allocation Study" from PPAnalyser, a data firm located in Amsterdam. The statistics are from 428 PPAs related to 2016 transactions (mostly U.S. companies). The study (now in its sixth edition) also provides economic useful life data used in PPA analyses. The median economic useful life of contract-related intangibles increased from 7.5 years in 2015 to 10 years in 2016, and the median economic useful life of technology-related intangibles decreased from 6 to 5.5 years. For marketing-related and customer-related intangibles, the economic useful life remained the same compared to 2015 (5 years and 10 years, respectively).

Telltale Signs of a Possible Ethics Scandal

When doing a company risk analysis, it would be helpful to know whether the organization is at risk of making headlines for corruption, fraud, or some other ethics violation. An article in the Harvard Business Review examined the thoughts of almost two dozen different experts to come up with certain conditions that make a company susceptible to ethical violations. One red flag is an overall atmosphere of urgency and fear, in which employees need to do whatever it takes for the company to survive (including maybe fraud). Another is a corporate culture of "success equals impunity," meaning that, when success is achieved through less-than-legitimate means, others in the company think the results justify the unethical behavior. These types of things could create a ticking time bomb.

What's the Value of Charles Manson's Image?

Just because you're one of the most notorious killers in history doesn't mean your name and likeness don't have value. But how much? According to a report, **Charles Manson's** son says there's $400,000 stashed away from the sale of T-shirts, photos, interviews, and the like. The money was reportedly hidden because Manson can't legally earn money this way. There's a legal battle going on over Manson's estate (and his body) between a grandson and a pen pal who claims he has Manson's last will that leaves everything to him, including image rights.

Recap of Some of 2017's Top Business Valuation Cases

Valuation issues are often integral to civil suits. Here is a selection of some the most educational cases of 2017.

In re PetSmart, Inc., 2017 Del. Ch. LEXIS 89 (May 26, 2017)

In a statutory appraisal decision, the Delaware Court of Chancery decided to "defer" to the deal price because the sales process "came close to perfection to produce a reliable indicator of PetSmart's fair value." In contrast, the court found the projections undergirding the petitioner experts' discounted cash flow analysis had all the "telltale indicators of unreliability."

DFC Global Corp. v. Muirfield Value Partners, L.P., 2017 Del. LEXIS 324 (Aug. 1, 2017)

In overturning a 2016 statutory appraisal decision by the Delaware Court of Chancery, the Delaware Supreme Court questioned the integrity of the Chancery's discounted cash flow analysis, particularly in light of the Chancery's post-trial (un-litigated) changes to the projections underlying the analysis. The Supreme Court made its preferred approach clear. "Market prices," it said, "are typically viewed superior to other valuation techniques because, unlike, e.g., a single person's discounted cash flow model, the market price should distill the collective judgment of the many."

Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd., 2017 Del. LEXIS 518 (Dec. 14, 2017) (Dell II)

Delaware Supreme Court Reverses Controversial Dell Decision

Only a few months after reversing the Delaware Court of Chancery's DFC Global decision, the Delaware Supreme Court did it again. It overturned the Chancery's controversial 2016 Dell opinion in which Vice Chancellor Laster found the deal price did not accurately reflect the value of Dell stock. To arrive at fair value, the Chancery relied on its own discounted cash flow analysis.

The impetus for this statutory appraisal action was the 2013 management buyout ("MBO") led by the company's founder, Michael Dell. The deal price was $13.75 per share, a 37% premium to the company's stock price. The court's DCF value was $17.62 per share.

Problems related to the sales process caused a mispricing whose degree could not be quantified, the Chancery said. It noted a "valuation gap" between the company's intrinsic value and its market value because the company's investors were too focused on short-term profit. No strategic buyers participated in the sales process. The participating private equity bidders all used an LBO model to determine their bid price rather than valuing the company as a going concern. This pushed the deal price below fair value. Finally, MBO-specific problems also undercut the credibility of the deal price.

The Supreme Court found the Chancery's decision not to assign any weight to the deal price was an abuse of discretion. "In fact, the record as distilled by the trial court suggests that the deal price deserved heavy, if not dispositive, weight." The Supreme Court faulted the Chancery for "ignoring the efficient market hypothesis long endorsed by the Court," which "teaches that the price produced by an efficient market is generally a more reliable assessment of fair value than the view of a single analyst, especially an expert witness who caters her valuation to the litigation imperatives of a well-heeled client." In disregarding the deal price, the Chancery overlooked the reality that, where Dell once was "a growth stock trading large multiples to its then-current cash flow," the market in recent years simply no longer "bought Mr. Dell's long-term vision," the Supreme Court said.

Brundle v. Wilmington Trust N.A., 2017 U.S. Dist. LEXIS 35811 (March 13, 2017); Brundle v. Wilmington Trust N.A., 2017 U.S. Dist. LEXIS 97752 (June 23, 2017)

This controversial ESOP litigation ended with the trial court's decision that the trustee had failed to engage in the valuation process and caused the ESOP to overpay by $28 million. The trustee immediately challenged the ruling in a post-trial motion, but, even though the court conceded it had made some valuation-related errors, it declined to change the outcome of the case. Stay tuned for the appeals court decision.

Perez v. First Bankers Trust Servs., 2017 U.S. Dist. LEXIS 52117 (March 31, 2017)

Not even three weeks after the Brundle decision came out, a different trial court adjudicating an ESOP case involving a New Jersey construction company reached the same conclusion: The trustee was liable for overpayment. Reliance on experts "is not a shield," the court said, finding the trustee failed to "make an honest, objective effort" to review the valuation report and question any assumptions and methods that did not make sense. Reports say the DOL and the trustee have settled the dispute and that First Bankers Trust Services will pay $8 million to the ESOP.

Hornberger v. Dave Gutelius Excavating, Inc., 2017 Pa. Super. LEXIS 1044 (Dec. 15, 2017)

Industry Practice Supports Discounts in Stock Redemption Valuation

In a buyback dispute litigated in Pennsylvania, the issue was whether the controlling shareholder agreement, which included provisions on how to value the shares of a terminated stockholder, contemplated the use of discounts. In affirming the lower court, the appellate court approved of the minority and marketability discounts, citing business valuation standards. The litigation involved opinions from three different experts who agreed in principle on when to apply the discounts but disagreed on their use in the context of the agreement. This case illustrates that even a well-developed valuation agreement does not foreclose a future lawsuit.

Weisfelner v. Blavatnik (In re Lyondell Chem. Co.), 2017 Bank. LEXIS 1097 (April 21, 2017)

This fraudulent transfer case hinged on the management projections supporting a merger that led to the formation of a company that went bankrupt a year later. The litigation trustee argued the seller had manufactured unrealistic projections to extract a higher sales price and that the merged entity was insolvent under the applicable financial tests. In a lengthy decision, the Bankruptcy Court found the projections aligned with the relevant entities' historical performance, contemporary industry studies, and, crucially, with the financial analyses by the banks underwriting the deal.

Slutsky v. Slutsky, 2017 N.J. LEXIS 120 (Aug. 8, 2017)

This protracted divorce case raised "the complex question of value surrounding a goodwill component attached to an interest in a law firm." The husband was an equity partner in a law firm, and the wife claimed she was not only entitled to a portion of the husband's partnership interest, but also to a portion of the goodwill value attributable to the firm, which she argued existed. The trial court sided with the wife, but its conclusory valuation and equitable distribution findings piqued the appellate panel, which remanded for review by a different trial court judge. A "nuanced methodology is required," the appellate panel warned.

Where's All That Tax Savings Going?

Tax reform is expected to put a lot more cash in business coffers. But how will that extra cash manifest itself in the future. Some indication comes from a survey by Morgan Stanley that showed Wall Street stock analysts expect companies to allocate 43% of tax savings to dividends and buybacks, 17% to capital spending, and 13% to workers. Some say that money used for buybacks is often better spent on improving operations and making workers more productive. "What are you getting from buying back stock? It doesn't generate any growth, any real activity," said James Abate, chief investment officer of Centre Asset Management.

Thoughts on Tax Reform's Impact on Business Valuations

Taxes—both corporate entity and individual—impact valuation, so the new tax law's trillion dollars of tax breaks create a significant impact on many aspects of business valuation. Of course, this will be an evolving discussion as experts study the new law and guidance emerges in the form of IRS regs. In the meantime, below are some initial impressions on business valuations under the Tax Cuts and Jobs Act.

Big Picture. Slashing the corporate tax rate from 35% to 21% will increase cash flow, of course, but how will this manifest in a discounted cash flow (DCF) model? Keep in mind that the reasoning behind the

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corporate tax cuts is to induce investment in plant and equipment, new technology, and increased wages to help the economy and benefit workers. Will this happen? Most mainstream economists doubt workers will see much benefit from the corporate tax cuts (see article entitled "Where's All That Tax Savings Going" in this newsletter).

Which industries will benefit most? It's hard to find an industry that does not benefit from the tax changes. In terms of dollars, the biggest tax savings from 2018 through 2027 go to manufacturers ($261.5 billion), insurance and finance companies ($249.4 billion), and retailers ($171.4 billion). There are also breaks for specific industries. For example, craft breweries will see a cut in the excise tax on beer. Wineries and distillers also get special tax breaks. Technology companies that have kept profits overseas will get a shot in the arm. Under current law, corporations must pay the U.S. corporate tax on overseas earnings—but not until the earnings are returned to the U.S. The new tax law allows a discounted one-time levy on those earnings that are returned to the U.S. Again, the issue is the use of the newfound cash in the coffers.

A huge tax change is in store for pass-through entities (PTEs), thanks to the new IRC Code Section 199a deduction that allows a 20% write-off of net income for sole proprietors, owners of S corporations, and members of partnerships/LLCs. But it's not that simple—Section 199a is 22 pages long with about 20 defined terms, dozens of cross-references within the new section and to other sections, and complicated computations. This will take time to sort out. But what's apparent is that the relative advantage of being an S corp versus a C corp will diminish, which will trigger a change in the debate over S corp valuations and the PTE premium.

Specific Impacts. The new tax law changes will affect many aspects of a business valuation practice. Here's a good overview of what to consider.

- Discounted cash flow methodology:
  - o Will immediately affect forecasts of income tax expense;
  - o Will immediately affect cost of debt in WACC;
  - o Forecasts of interest expense and NOL benefits may need to be revised;
  - o May affect optimal capital structure due to reduced benefit of debt financing and increased enterprise value; and
  - o May provide some industries with new advantages that impact growth and other assumptions.
- Market approach:
  - o Market multiples have been increasing throughout 2017 and likely already reflect adjustments; and
  - o M&A transactions occurring before the approval of the Act may not reflect the impact of the new tax law.
- Pass-throughs:
  - o The revised difference between the effective rate for C corps versus PTEs needs to be carefully considered; and
  - o This may impact methodology for tax affecting PTEs.

The new tax law doubles the estate exemption beginning in 2018. The exemption is now $11.2 million per person or $22.4 million per couple. The step-up in basis remains, so estates that would have benefitted from low valuations before the new tax law will now prefer to see high valuations.

The main changes in the corporate tax system will impact the larger corporations to a greater extent than smaller ones and international corporations even more so. Those changes are by and large permanent.

Determining future cash flows will be a bit trickier especially in the next year or so until the impact of the tax reform law on economic growth in the economy as a whole is known. One important change for small businesses is the ability to deduct capital expenditures to a greater extent in the year in which they are incurred. That should be taken into account in the cash flows as forecasted under the DCF methodology.

One important change for individuals with respect to divorce is that alimony is no longer deductible to the payer nor taxable to the payee. This will change the dynamic on divorce case negotiations.

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