VALUE MANAGEMENT INC.

Investment Banking + Advisory Services

ISSUES + UPDATES SUMMER 2018

Hidden Hazards of Selling a Business

For many business owners, selling a business occurs only once in their lifetime. They have spent their time developing their business, improving their products and services, dealing with employee issues, understanding their market, and adjusting to changing conditions. While selling a company may seem simple, especially when approached by a potential buyer, it can be far from it.

Irrational Exuberance – Most business owners would benefit from being realistic about what they have and what they can expect from a sale. Not all businesses are ready to be sold. The owner may have an unrealistic expectation of the value to be realized, the time needed to prepare for and to sell, the efforts required to run the business while trying to satisfy buyers, etc. It's better going in with your eyes wide open before you start the process.

Poor Timing – In real estate, it's location, location, location; when selling a business, it's timing, timing, timing! You may not like it, but you can't ignore it. Is it the right time for the owner(s)? Is the business ready for transfer and does its condition support the sellers' pricing requirements? Are economic conditions favorable to create high buyer interest?

An owner may want to sell but the business may not be ready. Market multiples may be below owner's expectations. Or, the owner and the business may be ready, but changes in economic circumstances decrease buyer demand and pricing. Be aware of relevant timing issues; if now is not the right time, fix what you have control over and watch and wait for the optimal time to sell.

Underestimating Value of Expert Advice – Minimizing or avoiding professional fees rarely yields a better return to the seller. Transactions are complicated and involve much more than a seemingly attractive

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VMI Highlights:

Value Management Inc. will be the Conference Sponsor at the Multi-State ESOP Conference on September 12th & 13th in Hershey, PA. Ed Wilusz, Susan Wilusz and Greg Kniesel will all be presenting at the conference. Ed's topic is "Can ESOPs Do That? When Business Decisions Affect Value." Susan is hosting a Woman's Networking and Discussion session. Greg's topic is "Best Practices to Help Trustees Sleep at Night." Please contact Susan Wilusz if you would like to learn more.

Kaitlin Wilusz, CFA has been selected by NACVA as a 2018 40 Under Forty Honoree. This distinguished group represents a cross-section of accounting and financial consulting professionals. Join us in congratulating Kaitlin!

VMI will be the sponsor of the Bucks County Estate Planning Council's September meeting.

On September 12th, Andrew Wilusz will be a presenter at Saint Joseph's University's Initiative for Family Business & Entrepreneurship. The program will address "Selling the Business to the Next Generation: How to Ensure a Smooth Transition."

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number offered by a professional buyer to an emotional seller. M&A advisors can help keep emotions in check, work with legal and other advisors to clarify the issues, maximize returns, minimize risk, and close a better deal.

House Not in Order – It is critical to know who currently does what and who will be needed to run the business. Hence, it is essential to have an accurate assessment of the owner's role in daily operations.

Unclear Financial Systems & Reporting – The ability to present and explain actual and adjusted financial performance to buyers is mandatory. Relevant financial systems and information should be reviewed and verified prior to presenting it to potential buyers.

Data Dump – Buyers will request and examine an exhausting amount of company information, ranging from the mundane to the integral. Owners generally find buyer information requests tedious and intrusive – and they are! Buyer requests are comprehensive and include data that owners rarely show to anyone (let alone to actual or possible competitors). The sensitivity of company data should be considered when preparing it for presentation to buyers. It's advisable to plan with whom and how you will share sensitive data, and when and under what conditions you will make it available. Controlling buyer access to company data will help protect the company's proprietary information and the owner's interests.

Sales of Small Businesses Are Expected to Increase

Nearly three-quarters (73%) of business brokers and advisors surveyed predict the volume of small businesses sold (under $50 million) will increase in the next 12 months, according to the "Q4 2017 Market Pulse Report," published by the International Business Brokers Association (IBBA), M&A Source, and the Pepperdine Private Capital Market Project. Two-thirds (65%) of advisors say that the Small Business Administration rules lowering minimum down payments from 25% to 10% will lead to more business sales this year.

Additionally, with the corporate tax rate dropping to 21% and the repatriation of overseas capital, companies will have more capital to allocate to acquisitions. Considering the heavy competition in the marketplace, it is likely that even more companies will be pursuing smaller market transactions. The Q4 2017 survey was completed by 264 business brokers and M&A advisors.

The Value of Private Companies has Increased per Pepperdine Report

According to new results from the "2018 Private Capital Markets Project" from Pepperdine Graziadio Business School, average company valuation multiples have increased from 8.0 to 8.7 times recast EBITDA for firms with EBITDA between $25 million and $50 million. The increases are similar for other deal sizes, which are also on the rise after a slight softening in 2016-17. The results are from a survey of investment banks.

"Last year, it looked like valuations were starting to soften a bit, after years of very high levels," said Craig R. Everett, Ph.D., finance professor at Pepperdine who runs the project. "However our current survey results reveal that valuations have been aggressively increasing again. Tax cuts and general business optimism are the likely reasons for this new surge in company valuations. It is definitely still a seller's market."

Extra Cash Flow From Tax Reform to be Invested

Much of the windfall savings companies are expecting from the new tax law will be used to increase domestic investment, according to a Deloitte survey of CFOs. They will also boost hiring and wages and repatriate cash abroad.

Most of the CFOs polled said they plan to use repatriated cash for investment in both core and new businesses as well as R&D, followed by debt repayments, buybacks, and dividends. While many expect some increase in hiring and pay, it does not account for as much of their anticipated spending as the other areas. The survey polled 155 CFOs, nearly all of whom are from companies with over $1 billion in revenue.

Delaware Court of Chancery Imposes Over $20 Million in Damages on Investment Fund and Its Manager

Basho Technologies Holdco B LLC v. Georgetown Basho Investors LLC, C.A. No. 11802-VCL (Del. Ch. July 6, 2018)

The above decision issued by the Delaware Court of Chancery holds an investment fund, Georgetown Basho Investors, LLC ("Georgetown"), its President and Managing Partner, Chester Davenport, and a Board member, Jonathan Fotos, liable for nearly $20.3 million essentially for destroying Basho Technologies, Inc.'s value. The litigation arises out of a once promising technology company's downfall into liquidation.

The facts stated that Georgetown leveraged a series of preferred investments into control and gained blocking rights. It used that control to secure a self-dealing financing unfavorable to the company, while simultaneously turning away much needed financing opportunities threatening its control. When the company was in a desperate financial state, Georgetown forced through a Series G financing which unfairly benefited Georgetown to the detriment of the company and other investors. Georgetown hoped to position the company for a prompt sale in which it would reap the benefits, but that did not pan out, and the company went under.

The judge acknowledged that it wasn't possible to trace the cause of Basho's demise with certainty, but concluded: "The evidence at trial convinced me that the Series G financing started the company on a greased slide to failure, and the defendants' actions after the Series G financing contributed to the company's completion of that journey."

The decision should serve as a cautionary tale for investors who position themselves with effective control in one form or another and thereby take on fiduciary duties. In that scenario, an investor engaging in a conflicted transaction with the company must rely on available procedural safeguards or be prepared to defend its actions as entirely fair. It also must walk a fine line when opposing opportunities that appear in the company's best interests. Also notable is the Court's damages award, which utilized valuations in connection with secondary offerings to determine values before and after the self-dealing financing.

Court Allows Tesla Dissenting Shareholder Suit to Go Forward

In re Tesla Motors Stockholder Litig., 2018 Del. Ch. LEXIS 102 (March 28, 2018)

The Delaware Court of Chancery let proceed a dissenting shareholder action that arose out of Tesla's acquisition of SolarCity. The Silicon Valley luminary, Elon Musk, has minority interests in both entities. The dissenters alleged breaches of fiduciary duties by Musk and Tesla's board. In response, the defense asked the court to dismiss the suit under Corwin, which says that the alleged breaches may be cleansed if a majority of disinterested and informed shareholders approved the transaction. Because Corwin does not apply if the transaction involved a conflicted controller, the central issue at this stage was whether Musk qualified as such.

As the court explained, Musk, who owned less than 50% of the voting power of Tesla, could still be considered a controller if he "exercises control over the business affairs" of Tesla. For their complaint to survive, the plaintiffs had to show either that Musk actually dominated and controlled the corporation and its board in terms of the challenged transaction or that he actually dominated and controlled the majority of the board generally.

The court found the plaintiffs presented enough evidence to show it was reasonably conceivable that Musk was Tesla's controlling stockholder. Although there was a 28% delta between Musk's ownership stake and a voting majority, other factors suggested he had the ability "to exercise the equivalent of majority voting control." The company took virtually no steps to separate Musk from the board's consideration of the transaction. He proposed the acquisition repeatedly until the board agreed to consider the proposal. He led the board's discussions with a "laser focus" on SolarCity as the acquisition target. Musk engaged the financial and legal advisors. The board never considered forming a committee of disinterested independent directors. By all accounts, Tesla's board members had conflicts of interest. Besides including Musk and his brother, the board included a very close friend of Musk, who also served on SolarCity's board at the time of the acquisition and who owned a private equity firm that participated in several pre-IPO funding rounds for Tesla and SolarCity. Several other board members also were owners or stakeholders in venture capital funds and private equity firms that had invested in SolarCity and benefited from the transaction.

The court agreed with the plaintiffs that three out of the five board members who voted for the acquisition were not independent.

The court concluded that, while the plaintiffs' complaint did not clearly state whether Musk regularly exercised control over Tesla's board or whether he did so only regarding the contested transaction, this distinction did not matter for ruling on the defendant's motion to dismiss. The facts stated in the complaint showed Musk was a controlling shareholder. Consequently, the plaintiffs' suit, alleging breach of fiduciary duty, could go forward to discovery, the Court of Chancery decided.

U.S. Department of Labor and First Bankers Trust Settle ESOP Lawsuits

THE BACKGROUND

The U. S. Department of Labor ("DOL") reached agreements to resolve four lawsuits with First Bankers Trust Services Inc. ("FBTS"). The lawsuits alleged that FBTS violated the Employee Retirement Income Security Act (ERISA) when it approved stock purchases by the Employee Stock Ownership Plans (ESOPs). As part of the agreements, FBTS paid approximately $16 million to the plans and reformed its procedures for handling ESOP transactions. Three of the settlements were reached in 2017 and the most recent one was reached in April 2018.

DOTTING "i"s & CROSSING "t"s

In each of the cases, FBTS served as a trustee and fiduciary of the ESOP, charged under ERISA with ensuring that the ESOP paid no more than fair market value for the employer stock. The DOL alleged that FBTS approved transactions without undertaking the due diligence required of an ERISA fiduciary, and ultimately caused the ESOPs to overpay by millions of dollars for the stock they purchased.

In one of the cases, the New Jersey district court held – after a 17-day trial – that FBTS breached its duties of prudence and loyalty when it caused the ESOP to overpay for shares of stock. Another case was the subject of a two-week trial before the New York district court in April 2017, but no judgement had been returned as the parties discussed settlement.

CHANGE IN POLICIES & PROCEDURES

As part of the settlement in one of the cases, FBTS also agreed to follow specific policies and procedures when it acts as a trustee or fiduciary to

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an ESOP that is purchasing, selling, or considering the purchase or sale of employer securities that are not publicly traded. These policies and procedures include requirements for the selections and oversight of a valuation advisor, the analysis required as part of the fiduciary review process and the documentation of the valuation analysis.

Expert's Valuation of Pork Trademarks Fails to Account for IP's Limited Use

Humane Soc'y of the United States v. Perdue, 2018 U.S. Dist. LEXIS 16118 (Feb. 1, 2018)

Many people are familiar with the pork-promoting slogan "The Other White Meat" (TOWM), which is the brainchild of the National Pork Producers Council (NPPC). Few people know that, in 2006, the National Pork Board (Board) agreed to buy a set of four trademarks associated with the slogan from NPPC. Based on the contract, the Board agreed to make annual payments of $3 million for 20 years. The Board had the ability to terminate the agreement for any reason by giving advance written notice. In case of termination, the Board would make a final payment before ownership of the trademarks would return to NPPC.

The Board, which is overseen by the Secretary of Agriculture, is responsible for promoting pork by way of a "checkoff" program (payments from producers and importers on the sale or import of the commodity). The annual payments required approval from the Secretary of Agriculture.

By 2009, the Board was aware that producers were questioning the value of TOWM. In 2011, the Board essentially retired the TOWM slogan and spent tens of millions of dollars on developing a replacement campaign focused on the slogan "Pork: Be Inspired." As a result, the TOWM slogan became a "heritage brand." Currently, the TOWM slogan appears somewhere on the Board's website, but the Board does not use it for promotional purposes. Of the four TOWM trademarks, the only one that is still in use is the blue "Pork and Design" logo.

Despite the new branding campaign, the Board kept making payments on the TOWM contract. In response, the plaintiffs—an individual commercial pork producer and two citizen groups—sued the Secretary of Agriculture (named defendant) and the U.S. Department of Agriculture. Initially, the plaintiffs challenged the agency's agreement to buy the trademarks and its approval of all related payments, particularly after the launch of a new branding campaign.

The agency's decision to continue the payments was based on a 2016 expert valuation that the reviewing court found unreliable because the valuation failed to take into account the current reality of the trademarks' very limited use.

The court said knowing that three of the four TOWM trademarks were no longer in use and that the board had invested millions in a new campaign that only uses the design logo, whose value was uncertain, "it is not logical to assume the current value of the three 'heritage' trademarks plus the logo is the same as the cost of developing an entirely new campaign from scratch." The court enjoined the secretary from approving future payments based on the 2016 review. The agency's decision to keep up the payments was unjustifiable, the court decided.

Provocative Delaware Chancery Decision Favors Stock Price Over Other Fair Value Indicators

Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., 2018 Del. Ch. LEXIS 52 (Feb. 15, 2018)

After the Delaware Supreme Court struck down the Court of Chancery's fair value determinations in DFC Global and Dell, the lower court sought to apply the high court's directives in another statutory appraisal proceeding. The Supreme Court said that, when there's an efficient market, "the collective judgment of the many," reflected in the deal price, provides a better gauge of fair value than a single analyst's discounted cash flow analysis. But what if there is more than one market indicator, as happened in the recent Court of Chancery case? Neither DFC Global nor Dell addressed this possibility, and the Court of Chancery's resolution of the issue is likely to trigger more litigation.

In May 2015, Hewlett-Packard (HP) acquired Aruba Networks for $24.67 per share. This was a synergy-driven transaction. As part of the statutory appraisal proceeding, the Court of Chancery found the deal price minus synergies was $18.20 per share. In contrast, the 30-day average unaffected market price was $17.13 per share.

The parties' trial experts offered discounted cash flow (DCF)-based valuations. The petitioners' expert arrived at $32.57 price per-share compared to the company's expert conclusion of $19.75 per share. The court disregarded the experts' DCF results and did not perform its own valuation.

The choice of most reliable indicator of fair value came down to stock price versus deal price minus synergies. The court, finding this was an arm's-length deal and there was an efficient market, said the stock price represented "direct evidence of the collective view of market participants as to Aruba's fair value." It was preferable to the deal price, which required adjusting for synergistic value as well as value related to the "reverse agency costs." Vice Chancellor Laster, who wrote this opinion as well as the original Dell opinion, thought the high court's opinions militated against the "judgment-laden exercise of backing out synergies." However, Vice Chancellor Laster also acknowledged that "no one argued for this result." The court's fair value was below the deal-price-minus-synergies and the company expert's DCF-based result, not to mention the petitioners' proposed value. Stay tuned.

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