VALUE MANAGEMENT INC.

Investment Banking + Advisory Services

ISSUES + UPDATES SUMMER 2019

M&A Basics: Buying A Business

Clarify and Define an Acquisition Strategy – Developing a good acquisition strategy starts with the buyer having a clear idea of what they expect to gain from making the acquisition. Different types of buyers (entrepreneur, financial, strategic) have varied reasons for purchasing a business. Entrepreneurs may seek new and different opportunities. Financial buyers often want businesses that they can grow and prepare to sell at much higher prices. Strategic buyers commonly desire to expand product lines, grow geographically, and gain access to new markets.

Consider the Financing of the Acquisition – While you don't have to pay for the business until the end of the business buying process (at the closing), it's important to consider how the deal will be financed. Does the buyer have their own funds to buy a business? Is a loan needed? Will seller financing be sought? It has been a seller's market for several years and there is much competition. Having your financing set up may increase your attractiveness to a seller.

Establish Search Criteria – Determining the key criteria for identifying potential target companies (e.g., type and size of business, profit margins, geographic location, customer base, etc.) is necessary for an efficient search process. Strategic buyers typically have the most focused criteria. Financial buyers also commonly define search parameters but may be open to a larger selection of opportunities. Entrepreneurs are more likely to take the broadest view of what they seek ("a business with potential") but would do well to narrow their search criteria.

Identify Acquisition Targets – The buyer uses their established search criteria to identify potential target companies. It's a good idea to identify as many companies as possible that meet the search criteria, including those which are not known to be for sale.

Contact Targets – Initial contact focuses on verifying that the target companies are interested in selling or would consider a sale. Most sellers don't wake up one day and decide to sell. Rather, someone initiates the process and gets the ball rolling.

(continued on page 2)

In This Issue:

VMI Highlights:

Congratulations to Susan Wilusz Marano and her husband Joe on the birth of their son, Joseph Edward Marano, born on May 9, 2019.

Value Management Inc. was happy to sponsor the Women's Networking Event at the NCEO Conference in Pittsburgh on April 10, 2019. Kaitlin Wilusz Long gave the opening remarks.

Ed Wilusz presented at the NCEO Pittsburgh Conference on April 9, 2019. The topic was *Can ESOPs Do That?*

Greg Kniesel also presented at the NCEO Pittsburgh Conference on April 9, 2019. The topic was *ESOPs in Business Succession & Estate Planning.*

Greg Kniesel presented at the 2019 Annual ESOP Association Conference in Washington, DC on May 24, 2019. The topic was *Fiduciary Responsibility for Value Determination.*

Andrew Wilusz presented at the Bucks County Bar Association on June 12, 2019. The topic was *The 7 Cs of Ethics for Estate Planners.*

(Continued from page 1)

Value Acquisition Target – The first step is to seek more detailed company information (financial statements, operations and marketing information, projections, etc.) that will enable you to evaluate the target. It could involve determining the price the you are willing to pay and an analysis of any additional value that might be attributable to potential cost savings and/or synergistic benefits.

Negotiations – Assuming an initial offer is reasonable, the parties will work to negotiate mutually acceptable terms (primarily financial and legal). If a provisional agreement is made on key financial terms (price, type & timing of payment, what's included in the sale), a letter of intent ("LOI") will be drafted, reviewed by the parties' legal experts, and signed. Most of the LOI terms are non-binding, except for the confidentiality clause and a period of exclusivity for buyer due diligence. Legal negotiations typically occur during the period of due diligence.

M&A Due Diligence – Due diligence is a comprehensive process that begins after the offer has been accepted. Due diligence aims to confirm or correct the acquirer's assessment by conducting a detailed examination and analysis of every aspect of the target company's operations – its financial metrics (revenue and profitability, assets & liabilities, cash flow), customers, suppliers, human resources, etc. It is typical that the buyer will have an exclusive right to perform due diligence for anywhere from 45 to 90 days. The exclusive right means that the seller cannot talk to other buyers during the period of exclusivity nor can it market its business for sale. In most instances, the deal will close at the end of the period of due diligence (for larger deals, government approval may be required before the closing).

Purchase Agreements – At a certain point during due diligence, assuming that the deal is on track, the parties' legal teams will negotiate the asset purchase agreement ("APA") and/or stock purchase agreement ("SPA"). The agreements cement the terms of the deal, as well as spell out the conditions of the sale, including the representations and warranties that the buyer and seller make to protect against mistakes and misstatements. Many people think negotiations end with the LOI, but it often continues during the period of due diligence, sometimes until the closing. It is not uncommon for deals to fall apart during this stage. The purchase agreements are crucial and represent the final, binding contract effecting the sale/purchase of the target company.

Integration Planning and Closing – The deal is ready to close, but is the buyer ready on Day 1 to hit the ground running with its acquired company? From the basics of announcing the deal to the employees, establishing new bank accounts, ensuring seamless receipt of revenue/payment of bills and wages, merging computer and software systems, to realizing potential cost savings and synergistic benefits, position changes, and putting new strategic plans into play, the buyer should be prepared at closing to run/integrate the acquired company. Integration planning should occur during the due diligence and be coordinated, as appropriate, with the seller. These days, the closing itself is somewhat anti-climactic as everything is normally done prior to the closing. More frequently in our increasingly electronic society, the buyer and seller may not even be in the same room on the day of closing. Commonly, signature pages are executed in advance and held by the attorneys until the prescribed events occur (often, this means that payment has been made).

SUMMARY – Buying a business is an involved process. The services of an experienced M&A professional can be very helpful in making a successful acquisition. From helping to set goals, to identifying, contacting and negotiating with buyers, to coordinating due diligence, legal negotiations and the closing, professional assistance will better enable the buyer to focus on what's most important - running the business.

PE Firms Relying More on Third Party Valuers

Private equity firms will use more independent valuation experts specializing in portfolio valuation and alternative, illiquid assets for fund-level analyses and financial reporting requirements, according to a new report. Fund managers are choosing between two distinct paths in this partnership: (1) an entirely outsourced portfolio valuation engagement; or (2) positive assurance, says the report. Valuation scrutiny has become a top priority for audits.

Value Drivers for a Hospital

Many factors can influence the value of a hospital. Some of the key value drivers for hospitals are as follows.

1. Location and Demographics of the Community

Similar to the real estate market, a hospital's location can have a significant impact on its value. Numerous aspects of a hospital's operations will be impacted by its location, such as its admission patterns, payer mix, and workforce. A hospital located near a major highway or in a highly populated area will tend to have high patient volumes. Rural hospitals may face difficulty in attracting and retaining physicians, particularly specialized physicians and surgeons.

Local community demographics can also significantly impact a hospital's value. Hospitals operating in an area with a large percentage of the population over 65 years of age may have a greater demand for its services than a similar hospital located in a college town with a younger population. A hospital operating in a lower socio-economic area will tend to have higher levels of Medicaid or uninsured patients.

2. Age and Appearance of the Facility

A hospital's age and appearance can significantly impact patient volumes, as patients and physicians prefer newer, modernized facilities. Hospitals are moving away from the older institutionalized construction toward a warmer and inviting "home-like" experience.

Additionally, hospitals are focusing on providing convenient patient care by investing in ambulatory care settings and delivering services into the community rather than adding new inpatient beds. The shifting of patient volumes from inpatient to outpatient settings has been a developing trend for a number of years, and the Affordable Care Act's emphasis on population health management and the medical home concept escalated this outpatient shift. As such, hospitals have focused new construction efforts on urgent care and primary care clinics to improve patient convenience and strengthen physician alliances.

3. Medical Staff Composition

Coordinated relationships with physicians in the community are integral to the success of a hospital. In past years, hospitals have concentrated their physician alignment strategies on direct employment of physicians. Recently, however, alignment strategies have become especially nuanced, including a variety of models such as:

- Co-management agreements;
- Professional service agreements;
- Clinically integrated networks; and
- Accountable care organizations (ACOs).

With the shift from fee-for-service models to value-based healthcare, a hospital's physician alignment strategy needs to be consistent with its overall mission and strategic plans.

4. Competition

As with any other business, the level of competition in the market area will generally have a material impact on a hospital's value. In recent years, hospitals have faced competition from not only other hospitals, but also other facilities such as ambulatory surgery centers (ASCs).

Because ASCs only provide day surgery services, they are much smaller than general hospitals and offer a much broader range of medical services. Plus, they are able to operate with a smaller staff and lower overhead levels. Due to their focus on select types of surgeries, ASCs typically offer the following benefits over hospitals:

- Patients are less at risk of being bumped or losing their scheduled surgery to more critical cases, as may often occur in a hospital setting;
- Because of their lower operating cost structure and efficient operating environment, managed care companies and insurance companies look favorably on ASCs and can often negotiate lower payments with ASCs for these medical services;
- Physicians are able to schedule their surgery cases in advance with less risk of being bumped;
- The nursing staff is familiar and well-trained in supporting the surgeries performed in the ASC; and
- Because of their focus on day surgeries, ASCs can draw less urgent cases from the hospitals, allowing hospitals to treat the more serious and traumatic cases.

5. Contracting Strength

A hospital's ability to negotiate and secure favorable reimbursement contracts with third-party commercial payers will generally have a positive impact on its profitability and value. Many small community hospitals have partnered or affiliated with larger healthcare systems in an attempt to garner more lucrative payer contracts. Typically, hospitals or health systems with a large presence in a market area can negotiate better commercial insurance rates than smaller hospitals. In determining value, it is necessary to understand the local commercial insurance market, the major commercial insurers within the community, and the hospital's leverage with these payers.

Deloitte Examines M&A Trends for 2019

Tax reform, a more relaxed U.S. regulatory climate, and growing cash reserves fuel optimism among U.S. dealmakers, according to a Deloitte report, "The State of the Deal - M&A Trends 2019." A recent uptick in merger and acquisition (M&A) activity shows no signs of slowing down, the report says. In this year's survey, 79% of respondents expect the number of deals they close in the next 12 months to increase, up from 70% last year.

Gateway Petroleum Technology, Inc.

has been acquired by

HABHEGGER Equipment

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Experts Clash Over Definition of 'Net Worth' in New Jersey Buyout Dispute

***Namerow v. PediatriCare Associates, LLC*, 2018 N.J. Super Unpub. LEXIS 2633 (Nov. 29, 2018)**

Business partners often think that a buyout agreement will forestall future conflicts. A recent New Jersey case proves the opposite. Not only did the agreement not prevent litigation, but it also did not bring about a fair outcome. The court recognized as much when it said the language in the agreement and the lack of any updated valuations gave it little discretion when determining the buyout price. This case points out the importance of reminding clients how important it is to periodically review any existing buyout agreement and obtain current valuations.

Flash point—intangible assets: The case arose after a founding member of a pediatric practice decided to retire after 38 years of practicing medicine. He had a 25% interest in the practice. Under an operating agreement, the members were bound by a valuation from 2000 because they had failed to agree to an updated valuation that accorded with the buyout provisions. In 2017, the retiring member sued. Ultimately, the court decided the agreement required a calculation of the company's value using the last agreed upon company value, $2.4 million, "adjusted to reflect the increase or decrease in the net worth of the company, including collectible accounts receivable since the last agreed upon value."

The plaintiff's expert proposed that "net worth" here included the value "beyond the net tangible assets on the books at that time [2000]. This intangible value, although unrecorded, is an asset of the company that would be considered goodwill." He developed a metric for calculating the value of the company's intangible assets in 2016. He concluded the company's value in 2016 ranged between $5.6 million and $6.75 million.

According to the defense expert, "net worth" was "the total amount of all assets minus all liabilities, as stated in the balance sheet." Under GAAP, he said, intangible assets such as goodwill are "not recorded on the balance sheet of an entity unless it is the product of an acquisition or some type of business combination." And, even in an acquisition, the inclusion of intangible assets on a balance sheet is the exception, not the rule, he noted. Adjusting the company balance sheets by including the value of collectible accounts receivable and excluding an amount that represented goodwill, he arrived at a range of value between $2.8 million and $3.2 million.

The court credited the valuation of the defense expert. Including intangible assets in the net value calculation was improper, the court said. It also said the plaintiff expert used a definition that allowed him "to manipulate the company value calculation for the benefit of the plaintiff."

But the court also was "mindful" that the plaintiff might feel "shortchanged" by the outcome. Therefore, it said it would use its limited discretion to adopt the higher amount in the defense expert's value range as the company's value in 2016.

Verizon's $4.6 Billion Impairment

What's in a (brand) name? One day a lot and then maybe zilch. Verizon will take a $4.6 billion write-down on Oath, its media brand that was formed in 2017 which includes Yahoo and AOL, says an article on CNN Business. When the company last did its goodwill valuation, the brand was valued at $4.8 billion. Is this one of the biggest blunders in corporate history? Interestingly, AOL was involved in another fiasco: the AOL-Time Warner merger.

Expert's Use of Wrong Damages Methodology Results in 'Grossly Inflated' Damages

At the Zayo Group v. Latisys Holdings, LLC, **2018 Del. Ch. LEXIS 540 (Nov. 26, 2018)**

A Delaware case turned on the interpretation of key provisions in the parties' sales purchase agreement. But the case includes a damages analysis from the court that deserves attention. The plaintiff claimed the contract required the defendant to make certain disclosures that the latter did not make. The Court of Chancery found the contract was ambiguous; however, based on extrinsic evidence, the court ruled in favor of the defendant. Although the court could have ended its discussion there, it decided to analyze in detail the damages evidence the plaintiff offered. The court noted the plaintiff's expert lacked experience in valuing going-concern businesses. This shortcoming, the court said, showed when the expert chose a methodology for calculating expectancy damages that did not fit the facts of the case, resulting in a "grossly inflated final damages number." According to the court, even if the plaintiff had prevailed on the liability issue, it would have lost on damages for failure to present a persuasive damages analysis.

Appellate Court Upholds Use of Risk Discount in Fair Market Value Determination

Saltzer v. Rolka, **2018 Pa. Super. Unpub. LEXIS 4044 (Oct. 30, 2018)**

Although unpublished, this Pennsylvania appellate ruling in a buyout dispute merits attention as it shows how the trial court tried to reconcile the contrasting expert valuations in determining fair value. Here, as is often the case, the members of a company executed an operating agreement but did not include a buyout provision for valuing a departing member's shares. This omission later became a liability when two members tried to force the third member out by devising their own buyback formula. Litigation ensued, leading to a trial and ultimately to an appeal because neither side was satisfied with the trial court's value determination. The court's valuation was substantially higher than the proposed buyout price, but the court, agreeing with the defendants' expert, found it was appropriate to apply a company-specific risk discount. The treatment of goodwill became another sticking point.

Forced sale. Three members created a closely held limited liability company that offered consulting services to state public utility commissions and the federal government. The company's main source of income was one contract that was structured as five contracts generating about $300,000 in profits per year. All three members worked for the company, receiving regular salaries. One served as the company's president and manager, and the other worked on the consulting side of the business. The third member, the plaintiff, was the specialist in information technology and served as VP of operations. As owners of the company, the members also periodically received profit disbursements in proportion to the size of their interests.

In April 2007, the members made an operating agreement under which the defendants (remaining members) each owned 400 units of the company and the plaintiff (departing member) owned 200 units. The operating agreement did not address a member's departure (by death or otherwise). In the next few years, the members talked about amending the agreement to include a buyout provision, but they took no action.

In May 2013, the defendant members fired the plaintiff. But the latter remained an owner and as such continued to share in the company's profits.

In June 2014, the defendant members decided to force the plaintiff out. As they together owned a majority interest in the company, they decided they could amend the operating agreement by devising a formula for determining the buyout price. The record later showed that the defendants arrived at the purchase price ($63,400) by "arbitrarily plugging numbers into their self-created formula." The appellate court later noted that the defendants "had no factual basis for the valuation."

To add insult to injury, the defendants gave the plaintiff a check for only 20% of the purchase price and two promissory notes for the remaining obligation. As the appellate court noted, in essence, the defendants made the forced-out member finance the buyback of his ownership interest. The plaintiff sued.

At trial, the parties presented valuation expert testimony. (However, the appellate court does not discuss the testimony in great detail.) The defendants' expert said that it was appropriate to discount the value of the company by 24% to account for the uncertainty around the valuation date as to whether the key contract would be renewed. The final (fifth year) portion of the contract was to expire in June 2016. However, by the time this case went to trial, the contract had been extended to December 2016. The defense expert also argued in favor of excluding the value of personal goodwill attributable to the two remaining members from the valuation.

In contrast, the plaintiff's expert rejected a personal goodwill deduction as well as a risk-based discount related to the company's largest customer because the contract in fact continued into the following years.

Date of valuation matters. The trial court found the remaining members had breached their fiduciary duty to the plaintiff and had acted in an oppressive manner when they forced a sale on their terms. The court said the plaintiff's expert was more credible and adopted its valuation. Therefore, the court did not deduct the value of personal goodwill from the company valuation.

However, the court agreed with the defense expert that a risk discount was appropriate under the facts of the case. Fair value was "the value on the date of dissociation," i.e., the value in 2014 when a renewal of the contract was not a certainty. The trial court valued the plaintiff's share in the company at $294,000. It declined to award the plaintiff punitive damages even though it recognized that the defendants' conduct vis-à-vis the plaintiff was close to outrageous conduct, as defined by law.

Both parties appealed the trial court's findings with the Superior Court of Pennsylvania (appellate court). The plaintiff challenged the application of risk discount, and the defendants attacked the trial court's decision not to allow a personal goodwill deduction. In addition, the plaintiff claimed it was entitled to punitive damages, considering the defendants' "recklessly indifferent" conduct.

The Superior Court affirmed. It agreed with the trial court that the existing operating agreement did not allow for an amendment by a majority of votes. Under the applicable state Limited Liability Company Act (LLCA), which governed here, the modification of the operating agreement required the unanimous vote of all members, not simply a majority of votes, the reviewing court found.

The appellate court rejected the plaintiff's argument that no evidence at trial "even remotely suggested that the stream of income from the ... contract would end," obviating the need for a risk-based discount. The valuation date was the date of dissociation, the appellate court affirmed. The plaintiff's expert improperly relied on information after the plaintiff had been made to leave. Also, the appellate court noted, the valuation findings were credibility determinations that were "well" within the trial court's discretion and with which the appellate court could not interfere. Likewise, the trial court, in balancing the circumstances accompanying the forced buyout, did not abuse its discretion in finding that punitive damages were not appropriate in the instant case.

The appellate court upheld the $294,000 valuation of the plaintiff's ownership interest.

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