VALUE MANAGEMENT INC.

Investment Banking + Advisory Services

ISSUES + UPDATES

WINTER 2018

The Stock Market and Its Impact on the Value of Closely-Held Businesses

The Dow Jones Industrial Average jumped past 25,000 for the first time on January 4, 2018, the index's fastest run to a fresh 1,000-point milestone in history. The S&P 500's long-running rally also reached a new landmark, becoming the greatest bull market in the postwar era. The broad index has more than quadrupled since the bull market began in March 2009, surpassing the tech-fueled rally of the 1990s, according to the research firm Leuthold Group, which excluded dividends from its calculations. The Dow has risen 283% over that same period, according to the Wall Street Journal Market Data Group. (UPDATE: Just seven days later, the Dow surpassed 26,000!)

Faster economic growth around the globe and improving sentiment from consumers and businesses have helped power this rally recently. Economic data in the first days of the new year continued to suggest steady expansion in the U.S., China and Europe. Analyst say that we shouldn't be surprised that markets continue to move higher because fundamentals continue to be positive and investor optimism is actually improving rather than investors becoming more cautious.

How does all this good news impact the valuation of a closely-held corporation? To a certain extent, they are along for the ride. However, the impact is industry and company specific. For high profit companies with good growth rates, the values are at all time highs. The stock market highs along with the new corporate income tax having a positive impact on company cash flow, relatively low interest rates, and investor optimism all point to higher values for closely-held businesses.

How long will the high values continue? Just like all good things, it won't last forever. Markets rise and fall. Predicting the peak is achieved by few. For the closely-held business owner, the stars are currently in alignment if the business and owner are ready to consider a liquidity event. Please contact us if you would like to discuss your options and value.

In This Issue:

VMI Highlights:

Value Management Inc. sponsored the Philadelphia Estate Planning Council's January 2018 luncheon meeting. The topic was Business Succession Planning presented by Turney P. Berry of Wyatt, Tarrant & Combs, LLP. If you are interested in receiving a copy of this 86 page presentation, please contact Susan Wilusz at smw@valuemanagementinc.com.

VMI sponsored the first local Women in ESOPs Networking Event held in Philadelphia on January 11th. If you are interested in joining us for future events, please contact Susan Wilusz.

Ed Wilusz and Greg Kniesel will be speaking at the NCEO's Annual Conference held in Atlanta in April. Ed's Topic is "Improving the Bottom Line: A Technical Look at Culture & Value." Greg's topic is "ESOP Fiduciary Responsibility for Value Determination."

SEC Settlement Over Fair Value Signals Shift of Focus

The settlement between KPMG and the SEC over alleged overvaluations of assets marks a shift in the agency's enforcement focus. Until now, the SEC primarily targeted policies, procedures, and internal controls. But, in this case, the SEC set its sights on the actual valuation of assets. The SEC order[1] is important in that it gives you an overall sense of where the agency will be focused in the future.

Significant matter. The case involves allegations of improper professional conduct and security law violations by KPMG and its audit partner relating to the review and audit of financial statements of Miller Energy, an oil and gas company based in Tennessee. During its fiscal year 2010 (ending April 30), Miller Energy acquired certain oil and gas interests in Alaska for $4.5 million. In its fiscal 2010 financial statements, the company reported these assets at $480 million. The SEC alleged that the valuation violated GAAP and overstated the assets by hundreds of millions of dollars. KPMG was hired for the next fiscal year's audit and also issued an audit report that gave an unqualified opinion to the company's 2011 financial statements that included as an opening balance sheet item the inflated $480 million.

After an investigation (apparently triggered by a critical financial blog), KPMG agreed to pay more than $6.2 million to settle SEC charges that it failed to properly audit the financial statements of Miller Energy. Specifically, the failures involved management's fair valuations of unproven oil and gas reserves and related fixed assets. Allegations included misuse of industry expert reports on reserves and tangible assets, a double counting of fixed assets, inadequate testing of assumptions, the auditor's lack of industry experience, and an inadequate disclosure of the work of the valuation specialists, which contributed to the improper valuations, according to the SEC order. KPMG and the audit partner on the engagement agreed to settle without admitting or denying any of the allegations, but they agreed to certain remedial acts and sanctions.

[1]In the Matter of KPMG LLP and John Riordan, CPA, SEC Release No. 81396 (Aug. 15, 2017).

Another Nonprofit Hospital Caught in Property Tax Crackdown

A nonprofit hospital in Pequannock, N.J., has settled a property tax dispute triggered by a challenge to its charity status, according to a report on NorthJersey.com. The hospital, the Chilton Medical Center, is operated by Atlantic Health Systems, the same entity that owns the Morristown Medical Center, which lost its property tax exemption back in 2015.

The Morristown hospital lost its property tax exemption because its activities were so intermingled with for-profit doings and questionable deals with physicians that it no longer resembled a charitable institution. Overly lavish executive compensation and perks were also a factor. Cash-strapped municipalities have jumped on this bandwagon, and, at one point, almost half of the state's nonprofit hospitals were caught up in tax court cases over property tax exemptions.

Under the settlement, Atlantic Health will pay Pequannock $262,500 annually through 2021 for community service and public health initiatives. This settlement may pave the way for similar deals with nonprofit hospitals being challenged in other municipalities.

Delaware No Longer Has Friendliest Lawsuit Climate

The state of Delaware is no longer in the top spot in the latest survey on the business-friendly environment for lawsuits in state courts. The "*2017 Lawsuit Climate Survey: Ranking the States*" ranks South Dakota in the No. 1 position—Delaware has dropped to No. 11, having been at the top for the last 10 surveys. The survey was conducted for the U.S. Chamber Institute for Legal Reform to explore how U.S. businesses perceive the fairness and reasonableness of the states' liability systems.

Some Tell-Tale Signs That a Forecast Is Unreliable

In fairness opinions, ESOP transactions, fair value determinations for financial reporting purposes and other appraisals, projections or prospective financial information is receiving much more attention. The following list is certainly not exhaustive, but it gives you a few of the warning signs that management prepared forecasts and projections may be unreliable.

1. *Ulterior motives.* That is, the forecast was prepared with an eye toward the valuation outcome (e.g., optimistic forecasts for bank financing; pessimistic forecasts for a business caught up in a divorce).
2. *Past forecasts have been inaccurate—they don't compare with historical results.* If they're always off the mark, why are these new ones reliable? Maybe the preparer just doesn't have the skill to do this.
3. *Forecasts are prepared with no input from business unit heads.* It is important to understand how and who prepared the projections. Some forecasts are prepared top down and are used as goals for the department heads.
4. *Growth rates and margins are inconsistent with analyst expectations for public firms in the same market.* What assumptions are behind these inconsistencies?
5. *No assumptions back up the projections, especially when the future is expected to be different from the past.*
6. *The forecast is predicated on some unusual assumption.* Be extremely skeptical and examine this assumption very carefully. Maybe the assumption relies on the ability to obtain financing or make an acquisition.

The Effects of Corporate Scandal

The corporate world is getting battered every day with new revelations of scandal. Of course, the first thoughts are with the victims of this misconduct. From a financial and valuation standpoint, there are consequences at many levels, explains Professor Aswath Damodaran (New York University Stern School of Business). Management distraction, lawsuits, fines, and penalties can all work to derail a company in the short term, but there are long-term effects as well.

Lasting damage: If the "corporate narrative changes as a consequence of the misconduct," a company can have serious long-term damage, Damodaran writes in his book, *Narrative and Numbers: The Value of Stories in Business*. "This is due to several reasons. The first is that the scandal can unalterably change the reputation of the company and, to the extent that its narrative was built on that reputation, its story as well. Thus, the news in 2015 that Volkswagen, a company that built its reputation on German efficiency and reliability, had cheated on emissions controls for its diesel cars in the United States could have altered your story line for the company and had large consequences for value. The second is that a key component or components of the company's business model may have been built on questionable business practices, which, once exposed, can no longer be continued. The third is that large scandals often result in management turnover, with the new management perhaps bringing a different perspective to the company."

Handling the Causation Issue in Damage Cases

Causation presents one of the most vexing problems for damages experts. Causation is a critical element in establishing a plaintiff's cause of action. It links the defendant's alleged misconduct to the plaintiff's claimed economic harm.

Broadly speaking, there are two types of causation requirements. The higher standard requires a showing that, "but for" the defendant's conduct, the harm would not have occurred. A less rigid standard requires a showing that the alleged misconduct was at least a "substantial factor" in causing the harm.

It's common for the retaining attorney to want to wall off the damages expert. Attorneys often ask experts simply to rely on the information or data the attorney or client provide. In complex cases, financial experts often are told to build their damages calculation on the conclusions a separate industry analyst provides. However, the expert takes a big risk if they simply go along with the attorney's modus operandi.

The key is to educate the lawyer why there is a need for the financial expert to speak directly with company management or the designated industry analyst. The damages expert should develop a thorough understanding of the case and the alleged causes of action. This may mean studying the company's financial history, the state of the industry, as well as the company's position in the market in order to determine and weigh all the factors that could have contributed to the plaintiff's claimed financial loss.

Please contact VMI if you have any questions in calculating damages.

Delaware Supreme Court Disses Chancery's Blending of Valuation Methods

In *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 2017 Del. LEXIS 324 (Aug. 1, 2017), the Delaware Supreme Court overturned a 2016 ruling by the Delaware Court Chancery that had blended the results of three valuation techniques to arrive at fair value. Chief Justice Strine, who once headed the Chancery, wrote a harsh critique replete with lots of advice to his successor, Chancellor Bouchard, on how to do a valuation.

The contested merger involved a global payday lending company that faced regulatory uncertainty in key markets and fierce competition. A private equity firm acquired the company. The chancellor, who handled the appraisal proceeding, performed a discounted cash flow analysis and also used the outcomes of the multiples-based comparable company analysis and the transaction price in calculating fair value. He weighted the results equally.

Post-trial, the company asked the court to correct an error related to the working capital figures in the Chancellor's discounted cash flow ("DCF") analysis. In response, the dissenters wanted an adjustment to the perpetuity growth rate based on their expert's affidavit that there needed to be a "codependent … and directionally consistent relationship" between the projected working capital in the DCF and the perpetuity growth rate. The court made both adjustments and achieved a fair value that was slightly higher than the original one.

The company appealed the decision with the Delaware Supreme Court. It asked the high court to create a judicial presumption, applicable in appraisal proceedings, that provides that when the merger that triggered the lawsuit was an arm's-length transaction, the merger consideration was the best indicator of fair value.

The Supreme Court declined to craft a bright-line rule. But it strongly agreed with the company that the Chancery's adjusted DCF analysis was highly problematic and that the weighting of the results of the three methods was not supported by the record of the case or by basic economic principles. "Market prices," the Supreme Court 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 based on all the publicly available information about a given company and the value of its shares."

The Supreme Court remanded, directing the chancellor to reassess the earlier valuation.

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Monkey Selfie Copyright Lawsuit Settled

A photographer will pay 25% of future royalties on selfies a monkey took to animal welfare charities. This is in a settlement between David Slater, the photographer/copyright owner, and PETA, which brought a lawsuit on behalf of the monkey. The animal rights group was seeking to extend copyright ownership to monkeys and all other nonhuman creatures.

Bananas: PETA sued on behalf of the monkey in 2015, seeking financial control of the photographs for the benefit of the monkey named Naruto that snapped the photos with the photographer's camera. A district court ruled that an animal could not own a copyright, and PETA appealed to the 9th Circuit, which was in the process of considering the appeal.

"PETA and David Slater agree that this case raises important, cutting-edge issues about expanding legal rights for nonhuman animals, a goal that they both support, and they will continue their respective work to achieve this goal," say PETA and Slater in a joint statement.

It's Still A Seller's Market In 2018 & No End Is In Sight (Yet!)

Conditions remain optimal for selling a business and owners who are prepared may see this as their window of opportunity. Despite three increases in the U.S. prime rate in 2017 (the latest on December 14th, bringing it to 4.5 percent), the telltale signs of a seller's market persist in 2018:

- general economic stability and/or economic growth
- positive equity markets
- cash on corporate balance sheets
- the availability of financing
- an abundance of buyers
- a relative shortage of quality sellers

Additionally, the window to sell high is being propped open by growing consumer and CEO confidence, and newly lowered federal corporate tax rates (flat 21 percent rate). If a successful company is considering a sale, is well positioned, and is prepared to be presented to buyers, given the huge demand and high prices recently being paid for top-performers, it very well could be a true window of opportunity for some business owners to sell at top value.

Tax Effects Are Relevant to Equitable Distribution Analysis in PA

In *Carney v. Carney*, 2017 Pa. Super. LEXIS 509 (July 11, 2017), the value of an auto transport business was one of the key issues in a Pennsylvania divorce case that went up on appeal. The appellate decision also includes a useful review of the issue of tax effects: Whether trial courts must or should consider the tax ramifications and expenses related to the potential sale of a business when dividing the marital assets.

The parties fought over the valuation of a successful auto trucking business that the husband had started during the marriage. Both parties offered valuation testimony from a set of experts: an asset valuation expert and a business valuation expert. The husband's experts used an income-based approach and arrived at a value of $1 million for the company. The wife's experts valued the company at nearly $2 million under an adjusted asset-based approach.

The trial court, under remand, adopted the $2 million value the wife's experts had proposed. Further, the court awarded the business solely to the husband but used the entire value of the business for equitable distribution purposes and stated that it was unnecessary to consider the tax effects and costs resulting from a potential sale of the business because the parties here did not intend to sell any of the assets.

In the appeal, the husband was successful in challenging the trial court's refusal to consider the effect of taxes and sales expenses related to the potential sale of the business. This error, the husband contended, skewed the equitable distribution findings.

The appellate court observed the divorce code expressly stated that tax ramifications related to a marital asset should be considered in the distribution analysis, "which ramifications need not be immediate and certain." Similarly, expenses related to the sale, transfer, or liquidation of an asset should be considered, "which expense need not be immediate and certain."

Further, case law supported the argument that tax ramifications and expenses associated with the sale of a marital asset had to be considered in the trial court's equitable distribution analysis regardless of "whether a sale was likely or not." See Balicki v. Balicki, 4 A.3d 654 (Pa. Super. 2010). Here, the reviewing court said, the husband's business could not be converted to cash without the husband's incurring considerable tax liabilities and sales-related expenses, whereas the wife would receive monthly cash payments without suffering any negative consequences. The reviewing court ordered the lower court to hold a hearing as to the tax effects and sale-related expenses on remand.

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