VALUE MANAGEMENT INC.

Investment Banking + Valuation Services

ISSUES + UPDATES WINTER 2022

Prince Estate and IRS Settle Valuation Dispute

***Estate of Prince R. Nelson, Deceased, Comerica Bank & Trust, N.A., Executor v. Commissioner of Internal Revenue*, Tax Court, Docket 11442-20.**

The IRS and Comerica Bank and Trust, the administrator of the estate of rock star Prince, have agreed to settle their dispute and agree on an estate value of $156.4 million, according to settlement documents submitted in the case. The agreed upon valuation is almost double the estate's valuation ($82.3 million) and close to the amount the IRS had determined ($163.2 million). Also, the IRS dropped a $6.4 million accuracy-related penalty it had levied on the estate. The matter had been set for trial but that has been cancelled.

Assets in dispute: The estate consists of real estate, music rights, Prince's name and likeness, and other assets. The IRS and Comerica settled on the real estate values last year, so the trial was to focus on the valuations of the other assets. Notable assets with disputed valuations included two entities: NPG Records, Inc. (Estate: $19.5 million; IRS: $46.5 million) and NPG Music Publishing LLC (Estate: $21 million; IRS: $36.9 million). The value of Prince's name and likeness was also in dispute, with the estate putting the value at $3.1 million versus the IRS expert's valuation of double that amount ($6.2 million). The settlement documents do not indicate the agreed upon valuations by asset type.

After receiving a notice of deficiency from the IRS (for $32.4 million plus penalties and interest) in 2020, the estate administrator filed a petition in Tax Court and the case was scheduled for this March. According to the settlement documents, the heirs to the estate indicated that minimizing the amount of estate taxes was "not their primary interest" and they expressed a "strong desire" to settle the matter and close the estate.

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VMI Highlights:

Value Management Inc. is proud to be entering its 31st year of business! We would like to thank all of our clients, colleagues and friends who have supported us throughout the years.

Ed Wilusz, Managing Director, will be presenting at the National Center for Employee Ownership (NCEO) Conference in Seattle this April. His topic will be "Tips on Preparing Projections for Your Trustee and their Financial Advisor".

If your firm is interested in having a VMI expert give an in-house or virtual presentation on business valuations and/or merger & acquisitions, please contact Susan Wilusz at smw@valuemanagementinc.com. We are happy to make a live or virtual presentation.

Clint Eastwood Awarded $6.1 Million in Right of Publicity Case

In a default judgment, actor Clint Eastwood has been awarded $6.1 million from a company that falsely claimed Eastwood had endorsed its Cannabidiol products. The lawsuit claimed that the defendants created fake news articles and manipulated search results to make it appear that Eastwood had endorsed their products. This case points up the intriguing valuation issue known as the “right of publicity.” This is a form of intellectual property that covers an individual’s likeness, including his or her name, image, signature, voice, and so on. As the Eastwood case shows, there could be a great deal of value when it comes to a celebrity.

Private Cost of Capital

The annual “Private Capital Markets Report” prepared by Pepperdine University provides an analysis based on an ongoing survey of expected rates of senior lenders, asset-based lenders, mezzanine funds, private equity groups, venture capital firms, angel investors, privately held businesses, investment bankers, business brokers, limited partners, and business appraisers.

The 2021 survey reveals that loans have the lowest average rates (banks require a median return of 3.3% to 5.5% depending on loan size) while capital obtained from angels has the highest average rates (ranging from a median of 23% for later-stage financing to 43% for seed money).

The cost of capital for privately held firms varies by capital type, size, and risk assumed. Pepperdine’s findings in the 2021 report on the median cost of capital rates are presented in the exhibit at the top of column two. The report contains much more detail, including first and third quartiles by different criteria such as amount of financing, EBITDA levels, and financing stage.

Private Capital Market Required Rates of Return

Type of Private Capital Funding	Pepperdine Median Rate of Return (Range)
Banks	3.3%-5.5%
Asset-based lenders	3.8%-16.0%
Mezzanine financers	10.0%-14.0%
Private equity groups	25.0%-30.0%
Venture capital groups	23.0%-38.0%
Angel investors	23.0%-43.0%

Approximately 21% of respondents indicated their business cost of equity capital is in the range of 9% to 10%, the range most cited. These low figures indicate that there may be a misunderstanding among business owners about the returns that investors require. We note that the majority of private firms that responded had 20 employees or fewer, with 46% having no more than five employees. Also, over half of them had annual revenues less than $1 million.

Pepperdine’s model for identifying a specific private cost of capital (PCOC) requires adjustments, just like any other method for deriving cost of capital. These adjustments are:

1. Determine which of the types of private capital match your subject company (all six may apply, or some subset).

2. Since a subject company is unlikely to meet the optimum requirements potential funders set, the median expected returns above need to be subjected to a risk adjustment. For example, if a manufacturer has a lower EBITDA, its cost of capital from the private capital markets might be closer to the upper quartile rather than the median figures from the Pepperdine results.

3. Each source of capital for the subject company must be valued so that a percentage of the total capital structure for each source can be derived.

4. The PCOC is the sum of the individual percentages for each capital source.

Dealmakers Look Forward to an Active Market in 2022

According to a recent survey of Association of Corporate Growth ("ACG") members, 80% of respondents said their outlook on Merger & Acquisition activity for 2022 remains positive. The volume of US middle-market buyouts from January through November 2021 came to $714.8 billion, eclipsing 2020's year-end total of $613 billion, according to Pitchbook. Pre-pandemic total deal volume amounted to $699 billion in 2019.

There was a lot of pent-up demand in 2021, both for buyers and for sellers. The expectation of capital gains tax changes may have also artificially inflated volume in 2021.

Some of the elements that drove a particularly busy year in 2021 will still be around in 2022, but will be less pronounced. Excess dry powder (cash sitting on the sidelines waiting to be invested), more companies in line to be sold and sellers looking at high valuations garnered by competitors all continue to be motivating factors for a strong pipeline.

Some of the industries that were hot in 2021, like technology, healthcare and services, will continue to be attractive in 2022. Some believe that pockets of consumer and industrials will also start to come back online. Additionally, some companies are using M&A to solve bottlenecks and shortages driven by supply chain issues.

Premium Gap Closes Between Strategic and Financial Acquisitions

The difference between the premium strategic buyers pay for acquisitions versus what financial buyers pay has decreased, according to recent data in the Factset MergerStat/BVR Control Premium Study. The study has 23 years of data from over 14,000 transactions across many different industries, and more than 60 different data fields are available per transaction.

The data fields include "transaction purpose," which identifies the transaction as either strategic or financial. The study defines the two transaction types as follows:

1. *Strategic.* This type indicates the acquirer in the transaction operates in the same business or industry as the target company. Unlike financial buyers, strategic buyers are often looking to find synergies with the target company and generally want to acquire the target and hold on to it, whereas financial buyers generally want to exit their investment in the target company within a relatively short time frame after the acquisition.
2. *Financial.* This type indicates the acquirer is making the acquisition for investment purposes and not for strategic business purposes. Financial buyers frequently include private equity firms, buyout funds, or any other finance company whose principal line of business is not directly related to that of the target company.

Overall, based on its 23 years of data, the study shows approximately 80% of all transactions involve strategic buyers, while 20% are financial. In general, you will see higher premiums on average for the strategic than the financial buyers. Historically, there's a 4% to 6% differential between the two types of premiums paid.

One thing to keep in mind is that, although the vast majority of acquisitions involve positive premiums, there is a meaningful number of transactions where the premium was below 0%. Restricting the data to the last five years (2016 to 2020) narrows the differential gap even further across all industries.

The proportion of strategic to financial buyers is still largely the same (roughly 82% to 18%), but the tighter differential could be due to the influx of financial buyers—private equity funds and financial sponsors with access to greater funds and lower interest rates—paying slightly more on average than they have in the past, while, on the strategic side, the premium has decreased slightly.

ESOPs and DoD Contracts?

ESOPs working in the government contracting space have long sought recognition in the contracting process for the unique benefits employee ownership provides for workers and communities. For the first time, some modest traction has been gained toward that goal in Department of Defense (DoD) contracts. Included within the National Defense Authorization Act (S. 1605) that was signed into law on December 27, 2021, is a potential pilot program that the DoD may establish to incentivize contracting with employee-owned businesses. This is an enticing opportunity and is already providing some greater exposure for ESOPs in government contracting.

One significant area of this bill relates to defense contracting and procurement, and in this area was a modest win for ESOPs. Section 874 provides the Secretary of Defense the authority to establish a pilot program for 100% ESOP companies that are S corporations to continue their existing contracts with the DoD under certain circumstances without recompeting for the contract. The goals of this pilot program are to incentivize the use of ESOPs by the DoD, encourage companies to become 100% ESOPs by providing this incentive, and streamline existing contracting procedures.

Once a contract is established with a qualifying ESOP company for a good or service provided to the DoD, a follow up (aka future) contract for the same product or service may be granted without returning to the competitive bidding process. These ESOP companies, of course, will need to be rated satisfactory or better in applicable performance review databases. And initial (first time) contracts will still require competitive bidding, which helps ensure fair and open competition to provide the best price for the best good or service.

It is important to note several things: the law gives the DoD the authority to establish this pilot program but does not mandate it; the pilot program may be established only after some data collection and planning are submitted to Congress; and the pilot program is only authorized for 5 years. So, like nearly all laws, the referenced language will need implementation by the agency, in this case the Pentagon, before the full details are revealed. And all of this is subject to the Secretary of Defense pursuing the program at all – so like most advocacy efforts, there is always still work to be done.

How to Stay Out of *Daubert* Trouble

The last thing any financial expert wants is to get excluded from testifying in court.

Rule 702 of the Federal Rules of Evidence governs the admissibility of expert evidence in federal courts, including the Tax Court. The landmark *Daubert* case in the U.S. Supreme Court recognized what kind of scientific testimony would be admissible in federal court and some state courts.[1] Later, the *Kumho Tire* case extended this concept to nonscientific testimony including that of financial experts.[2] Rule 702 also governs the interpretation and application of the *Daubert* case. Another key case is *Joiner*, which clarified *Daubert* and held that, when the expert's opinion is not sufficiently linked to the actual facts of the case or the appropriate data or is linked only by the expert's own authority or interpolation, the trial court need not admit the opinion even if the methodology is an accepted methodology.[3] These three cases are sometimes referred to as the "*Daubert* trilogy."

In 2019, 224 challenges to financial expert witnesses were reported, an increase of 8% from 2018, according to the PwC survey, "Daubert Challenges to Financial Experts."[4] Of these reported challenges, 37% of them resulted in partial or full exclusion of the expert.

The annual PwC study analyzes challenges to financial expert witnesses under the *Daubert* standards from 2000 to 2019, the years following the U.S. Supreme Court's *Kumho Tire* decision. For this study, financial experts include such professionals as accountants, economists, statisticians, finance professors, financial analysts, appraisers, and business consultants. The three most common types of financial experts

(Continued on page 5)

[1] *Daubert v. Merrell Dow Pharmaceuticals, Inc.,* 509 U.S. 579, 589 (1993).
[2] *Kumho Tire Co. v. Carmichael,* 526 U.S. 137, 159 (1999).
[3] *General Electric Co. v. Joiner,* 522 U.S. 136 (1997).
[4] pwc.com/us/en/services/forensics/pdf/pwc-daubert-study-2020.pdf.

(Continued from page 4)

engaged to provide financial expert witness testimony are accountants, appraisers, and economists. Of these three types of experts, the study finds that, over the last 20 years, accountants and economists are the most frequently challenged financial expert witnesses, while appraisers are the least frequently challenged. In 2019, accountants and appraisers had the highest exclusion rates of the three most common financial experts, at a rate of 43% each.

Key insights. The "reliability factor" is where most of the court fight happens in terms of whether an expert's testimony is admitted or not. The *Daubert* case provides a multipronged test for the reliability of expert testimony: (1) the expert's methodology has been tested; (2) it does not overly rely on subjective interpretation; (3) it has been peer-reviewed and published; (4) it is commonly accepted by professionals in the field; and (5) whether the theory or technique is used in a nonjudicial context.

The one that catches most financial experts? The second factor—subjective interpretation—is the one that leads to the most exclusions. That is, the client or attorney asks the expert to make assumptions that do not hold up, which especially happens if those assumptions are not entered into evidence prior to the testimony of the expert. Red flags that there is too great a level of subjective interpretation, which will lead to exclusion, are:

- Opinion based solely on expert's "education, training, and experience" with insufficient underlying support (lack of methodology);
- The foundational data are unreliable; and
- Too great of an "analytical gap" between the data and the opinion proffered.

In terms of *Daubert* challenges, some observe that, in a bench trial (versus a jury trial), the judge is more likely to deny the motion to exclude an expert witness, hear all the evidence, and accord the expert testimony the appropriate weight based on the law.

An example of when an expert was excluded was for reliance on "yet to be signed contracts years into the future ... without analyzing [the plaintiff's] historical profit margins or typical industry profit margins" and was too speculative to be admissible. This was particularly problematic because the opinion was also based upon the plaintiff's "say-so" on its sales and its ability to continue sales at the same level. The court excluded the expert because "[e]xperts may not assume facts without some support for those assumptions in their expert report or elsewhere in the record."[5]

Another dangerous flaw is an expert's inconsistent application of valuation methodologies from a prior case to the next.[6] True, different methodologies may be appropriate in one situation and inappropriate in another in lost profits cases. But the expert and attorney need to be cognizant of whether the expert has previously testified that a methodology he or she is using in the present case was inappropriate or caused an inaccurate result in a prior case. Also, issues will arise when an expert who has used a methodology in the past opines that it was inappropriate for the opposing expert to use that very same methodology. Under these circumstances, it is important to explore the previous opinion to determine whether distinguishing characteristics in the prior case are such that the expert can explain the seemingly contradictory positions.

[5]*Multimatic, Inc. v. Faurecia Interior Systems USA, Inc.*, 2009 U.S. App. Lexis 28156 (6th Cir. 2009).

[6]See, e.g., *Port Authority of New York and New Jersey v. Affiliated FM Ins.* Co., 245 F. Supp. 2d 563, 568 (D.N.J. 2001) (excluding an expert in an asbestos case when the expert's own sworn testimony in other matters had previously stated that the method applied in the current case was "unreliable, inadvisable, or unsupportable.").

Apple is Still the Most Valuable Brand, per Brand Finance Study

Apple has retained the No. 1 spot on the list of the world's most valuable brands, according to the "Brand Finance Global 500 Report 2022." The pandemic has boosted its value as people relied more on technology during the crisis. Plus, Apple has been investing in products and services that go beyond small devices. Amazon and Google are second and third in brand value, respectively. Technology remains the most valuable industry, while retail overtook banking for second place. On the rebound from COVID-19 are airlines (brand values are up after two years of double-digit declines) and hotels. The fastest growing brand is TikTok, and the world's "strongest" brand is WeChat (for the second year in a row), says the study.

A Buyer in Hand? Or, Are You in the Buyer's Hand?

Selling your business on your own can be compared to representing yourself in court - it's hard to find anyone (other than some buyers and opposing counsel) who would recommend that it's a good idea!

One can appreciate a seller's concern over establishing a good working relationship with the buyer that will be sustainable post-transaction. This is a common goal for sellers/partners who will continue at the business. When the seller has an existing relationship with the buyer, the desire to preserve that relationship sometimes leads them to think (often with "help" from some buyers) that it would be better (i.e. easier and without fees) if they handled the sale on their own.

The challenge in many deals, of course, is to balance establishing/maintaining the optimal buyer/seller relationship while at the same time negotiating with the buyer to achieve pricing goals on terms favorable/acceptable to the seller. Some sellers think that having an intermediary represent them could disturb their relationship with the buyer. However, experience proves that the opposite is true: professional involvement notably helps foster and preserve the buyer/seller relationship (despite it being fairly common for some buyers to imply otherwise).

The sale process brings emotions to the surface - particularly during negotiations and due diligence (where negotiations of some type often continue until closing!!). Having a professional buffer/surrogate helps to foster the desired relationship with the buyer and can be key to getting the target value on acceptable terms for the seller.

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