

# Viewpoint on Value

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# M&A deal skyrocket: Ways to operate sale-ready

There has been a surge of mergers and acquisitions in 2014 — up 75% globally in the first half of the year to its highest level since 2007, according to Reuters. The outlook remains strong for public and private companies into 2015. This is good news for business owners, especially baby boomers contemplating retirement.

You never know when a strategic buyer might make an offer that's too good to refuse. Here are some recent M&A trends and ways for businesses to operate sale-ready to fetch top dollar in the marketplace.

## Understanding M&A trends

Hot sectors for business combinations include telecommunications, health care and life sciences, energy, gas and oil, and consumer product manufacturers. In addition, a significant portion of this year's M&A activity has involved so-called megadeals, involving public companies like Time Warner Cable and SFR.

The transaction frenzy has trickled down to small and middle market private companies as well. Last year, private deal volume was up 49% and continues to rise. Deal activity among U.S. small businesses was up 11% in the first half of 2014, compared to the same period last year, according to BizBuySell Insight Report. That's the highest deal volume since the second quarter of 2008.

Market conditions are ripe for continued deal-making activity:

- Financing is relatively inexpensive (and available).
- Corporations have excess cash on their balance sheets to invest in M&A.
- Business performance has generally improved.
- The supply of for-sale businesses has increased.



- Managers and investors are increasingly confident in the general economic outlook.

Many of today's buyers are strategic players — such as competitors or suppliers — who understand the seller's industry and may be willing to pay a premium, because they can achieve synergistic benefits that the average “hypothetical” buyer cannot.

In fact, buyers paid on average 13 times earnings before interest, taxes, depreciation and amortization (EBITDA) in the first half of 2014. That's the highest average EBITDA multiple since 2008, according to Reuters data. The average price-to-EBITDA multiple in the first half of 2013 was only 11.8 times. Pricing multiples vary significantly from company to company and industry to industry, however.

## Operating sale-ready in a hot market

Beware that financial buyers are still trolling for bargain-priced businesses to turn around and “flip.” So, business owners shouldn't take the first offer they receive without consulting with valuation professionals. A business may be more valuable than its owners anticipate in today's market. A valuator can help explain how potential buyers might perceive the

company and identify possible strategic buyers who'd be willing to pay top dollar.

Planning is essential to maximize the selling price. The first step is finding a valuator to help management identify key value drivers in the company's industry. Potential buyers are attracted to businesses with high expected cash flows and low risks. Valuators can recommend ways to improve both sides of the valuation equation — by improving weaknesses, mitigating risks, and playing up core strengths and emerging opportunities.

## A valuator can help explain how potential buyers might perceive the company and identify possible strategic buyers who'd be willing to pay top dollar.

For example, the owner of a high-tech company (Bob) contacted a local business appraiser (Barb) in 2013 about selling. She suggested that he wait a year to get his house in order. Her recommendations

included implementing noncompete agreements with developers and entering into long-term contracts with key customers — as well as finalizing an important pending patent. Bob also lowered his salary to market rates and stopped running personal expenses through the business. And he divested an unrelated side business that he wanted to pursue after closing.

Before soliciting offers, Barb helped Bob create an offering package that included audited financial statements and positioned the company as a “nimble innovator in cybercrime prevention.” She also identified two large technology companies with complementary offerings that were in acquisition mode. Bob's company was sold to a prospective buyer in early 2014 for a 25% premium above fair market value.

### Putting people before money

Experienced M&A advisors understand that the decision to sell a private business is a personal one for owners. A strategic buyer might offer the highest price — but might not be the best option for loyal employees or the owner's family members.

Valuators can brainstorm options that balance the owner's financial goals with his or her personal prerogatives. In some cases, a management buyout, gifts to family members or charities, or an employee stock ownership plan (ESOP) is an owner's preferred choice. Valuators can help handle the administrative aspects of these exit strategies, too. ●

## Strategic acquisitions offer growth opportunities

As the supply of for-sale companies mounts, it may be time to consider buying a competitor, supplier or customer. Sometimes it's easier to grow through a merger or an acquisition, rather than building up in-house capabilities — especially if the buyer's weaknesses are the seller's core strength.

For example, a manufacturer was known for innovative, high quality products, but its sales department struggled with underperformers and high turnover. So, it merged with a competitor that had a highly motivated and experienced sales team. The combination helped both companies overcome their weaknesses — and it dramatically lowered overhead costs for the combined entity.

But the buy-side isn't without risks. A valuation professional can objectively evaluate whether management's expectations regarding cost-reduction and revenue-building synergies appear realistic. He or she can also recommend creative deal terms to lower the buyer's risks.



# Mapping out standards of value

Business valuations can go in 4 directions

Value means different things to different people. So, before starting any appraisal assignment, it's imperative to map out the appropriate "standard of value" to ensure that everyone arrives at the same point. If not, the parties are likely to end up off course — or in need of backtracking.

A well-written appraisal report clearly defines which of the following four standards of value is right for your current appraisal needs.

## 1. Fair market value

This is the most common standard of value, especially for gift and estate tax purposes and shareholder buyouts. IRS Revenue Ruling 59-60 defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

When estimating the fair market value of a business, it's important to remember that there are two sides

to the coin: a willing buyer and a willing seller. Fair market value is essentially a compromise between the "universe" of hypothetical bid prices (the buyer's position) and ask prices (the seller's position).

## 2. Strategic value

Strategic (or investment) value — the value unique to one party — is the preferred standard in business combinations. Investment value considers a specific investor's expectations, risks, tax situation and synergies.

When quantifying investment value, appraisers frequently focus on the discounted cash flow method over other valuation techniques. Key inputs include management's projected cash flows, expected growth rates and the combined entity's expected cost of capital.

In successful business combinations, the value of the combined entity usually exceeds the sum of the parts operating independently. This incremental value commonly is referred to as "synergy."

Fair market value is a logical starting point for valuing synergy, but rarely an ending point. Instead, sellers hold out for strategic buyers, who often are willing to pay a premium for control attributes and synergy.

## 3. Fair value — financial reporting

In many ways, fair value for financial reporting purposes is similar to fair market value as defined in the Treasury Department regulations. Both standards of value assume an exchange price that involves hypothetical buyers and sellers with both parties knowledgeable, unrelated, and able and willing to transact. In addition, buyer-specific synergies are excluded from the company's fair value.

There are some subtle differences between the two terms. Fair value may contain some elements of investment value. For instance, in September 2006, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 157,





*Fair Value Measurements* (SFAS 157), introduced the concept of “market participants,” which refers to buyers and sellers in the principal (or most advantageous) market for the asset or liability.

Thus, the pool of market participants in a hypothetical fair value transaction may be smaller than the entire universe of potential buyers and sellers considered when estimating fair market value. The principal market is also entity-specific and may vary from company to company.

#### 4. Fair value — litigation

The term “fair value” may also be statutorily defined. Legal statutes and precedent use this term so they’re unencumbered by IRS and U.S. Tax Court interpretations of “fair market value.” Fair value in a legal context is often guided by an underlying principle of equity.

For example, courts deciding marital dissolutions or shareholder oppression cases may seek the fair value of a business interest in the hands of the controlling shareholder, rather than to a hypothetical shareholder. That’s because the application of discounts for lack of control or marketability may provide controlling shareholders with a windfall when divvying up marital assets or buying out minority shareholders. In essence, the transaction is frequently between a willing buyer and an unwilling seller. In addition, fair value may exclude all (or part) of the company’s goodwill in marital dissolutions in some jurisdictions.

#### Get it right

Measuring the wrong standard of value may cause an expert’s conclusion to be excluded from evidence — or lead to misinformed business decisions. A little extra attention to standard of value on the front end can eliminate big problems on the back end. ●

## 5 questions to gauge valuation expertise

All experts aren’t created equal. If you hire someone to appraise a private business, he or she should specialize in the business valuation discipline. This requires years of training and experience. Generalists who merely dabble in business valuations are unlikely to withstand IRS scrutiny or cross-examination by opposing counsel if the appraisal winds up in court.

Here are five simple questions to help you differentiate specialists from generalists in the business valuation realm.

### 1. What are your credentials?

In the early 1990s, the business valuation discipline was relatively uncharted territory. Today there’s a significant body of knowledge that experts can

draw upon. In order to keep up to speed on the latest developments, financial professionals need to receive ongoing training and maintain credentials from one of the following recognized U.S. valuation organizations:

- The American Institute of Certified Public Accountants (AICPA),
- The American Society of Appraisers (ASA), or
- The National Association of Certified Valuation Analysts (NACVA).

In 2012, the Institute of Business Appraisers (IBA) merged with NACVA. Each of these organizations imposes specific coursework, experience,



peer review and continuing professional education requirements on its members. Double check that the expert you're hiring (or cross-examining) has successfully completed all of these requirements.

## 2. What's your track record?

Ask if an expert specializes in a particular type of case. For example, divorce attorneys typically want experts who take on an equal number of husbands and wives as clients. Someone who's always trying to get the lowest possible value for monied (or controlling shareholder) spouses might also be perceived as a "hired gun" in the eyes of the judge or jury.

You also want an expert who's an asset in court, not a liability. Use seasoned experts over novices, and review previous court transcripts to see whether an expert made mistakes or became flustered on the stand. Previous court testimony might even contradict something a valuator says in deposition or during direct examination.

## 3. Can you define "fair market value"?

This is a basic question that every valuation expert should be able to answer off the cuff. An expert's response should include three elements — a cash-equivalent price, willing and informed buyers and sellers, and no compulsion to transact — under IRS Revenue Ruling 59-60 and the *International Glossary of Business Valuation Terms*, a publication of all the appraisal organizations listed on page 5.

## 4. What are the three valuation approaches?

Valuators use the cost (or asset-based), market and income approaches to value businesses. Various valuation methods fall under these broad approaches. For example, the capitalization of earnings and discounted cash flow methods are classified under the broader income approach.

Although valutors consider all three approaches in every appraisal, they may use only one approach (or combine the results of a couple of approaches) to arrive at their final conclusions. An expert should be able to explain these approaches using terms that laypeople can understand — and explain which are most relevant to the case at hand.

In order to keep up to speed on the latest developments, financial professionals need to receive ongoing training and maintain credentials from a recognized valuation organization.

## 5. Can you explain the DLOM?

The discount for lack of marketability (DLOM) doesn't apply in every case. But it's one of the more technical aspects of valuation science. An expert who can easily explain this concept — including sources of empirical data, the method used to quantify the DLOM and whether it applies to the case at hand — demonstrates that he or she is more than a novice in the business valuation discipline. It can also show the expert has strong verbal communication skills.

There are thousands of questions you might ask to gauge a valuator's qualifications and the reliability of his or her conclusions. We've provided a few basic ones to serve as a simple "smell" test. If an expert passes this initial screening, you'll know you're on the right track. ●

## Minority shareholder disputes

# Don't always count on stock-purchase agreements

Business owners enter into stock-purchase agreements to facilitate buyouts upon certain triggering events, such as a shareholder's death or divorce. But sometimes courts disregard these agreements, leaving shareholders vulnerable to paying (or receiving) an amount mandated by a judge, who may not be familiar with the parties' preferences or financial conditions.

### Case in point

In a recent Minnesota Court of Appeals case (*Piche v. Braaten*), a minority shareholder had entered into a stock-purchase agreement with three majority shareholders in 2006. Four years later, his employment was terminated and the majority shareholders froze him out of the corporation due to "hostile and offensive misconduct in the workplace."

The stock-purchase agreement originally called for the minority shareholder to receive monthly installments of \$8,333 over 15 years — a total of roughly \$1.5 million — upon his death, divorce or bankruptcy. It also required the shareholders to revise the purchase price annually.

A Minnesota district court ordered a buyout of the minority shareholder's interest as of December 31, 2010. At the time of the court-ordered buyout, the minority shareholder had accrued a 22% interest in the company.

Both sides hired valuation experts. The plaintiff's expert valued the minority interest at \$2.176 million using the market approach. The defendants'

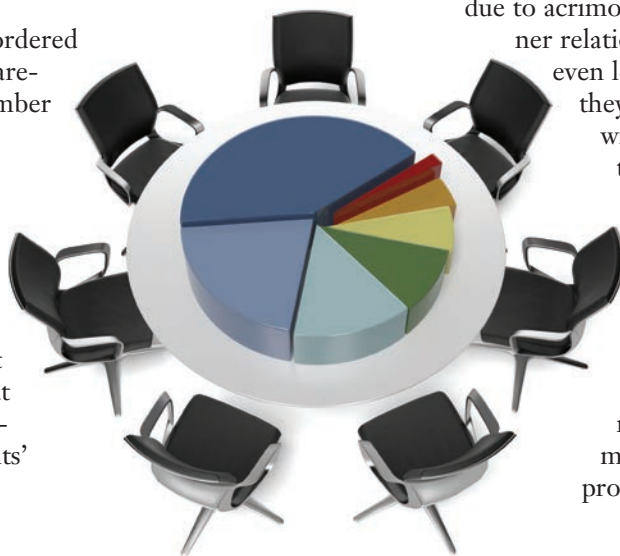
expert valued it at \$1.296 million, also using the market approach.

The district court decided that the stock-purchase agreement didn't apply because the parties didn't anticipate a court-ordered buyout as one of its triggering events — and they never obtained updated appraisals in accordance with the stock-purchase agreement. After considering the conclusions of both expert witnesses, the district court valued the minority interest at \$1.621 million, due immediately as a lump sum.

The appellate court upheld the lower court's valuation of the minority interest. But it ruled that the district court should have allowed for monthly installment payments over 15 years, in accordance with the stock-purchase agreement. During trial, the majority shareholders testified that monthly installment payments were intended to preserve the company's solvency.

### Lessons learned

Stock-purchase agreements can't premeditate every buyout scenario, especially court-ordered buyouts due to acrimonious shareholder or partner relations. These agreements are even less likely to be upheld when they've sat on a shelf for years, without being reviewed. Rather than rely on a value or buyout terms stipulated in a stock-purchase agreement, protect yourself with a valuation professional. He or she can help ascertain whether the valuation provisions of a stock-purchase agreement remain relevant in today's marketplace and periodically provide updated appraisals. ●





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**John M. Leask II (Mac), CPA/ABV, CVA**, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuers.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuers' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at [www.LeaskBV.com](http://www.LeaskBV.com).

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at 203 - 255 - 3805. The fax is 203 - 380 - 1289, and e-mail is [Mac@LeaskBV.Com](mailto:Mac@LeaskBV.Com).

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If you have a business valuation problem, Mac is always available to discuss your options — at no charge.