

# VIEWPOINT ON VALUE

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See for yourself  
Site visits are a critical part of the valuation process

Court increases dissenters' buyout offer by more than 25%

Using a "yardstick" to measure damages



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# 3 reasons why selling price isn't necessarily a cash-equivalent value

The saying “a bird in the hand is worth two in the bush” rings true when evaluating the time value of money. That is, depending on an investment’s risk and payout period, \$1 paid out today could be worth more than \$2 promised to be paid far in the future.

How does this concept relate to business valuation? When the value of a business is based on the sales of comparable companies under the guideline merger and acquisition (M&A) method, it’s important to understand the cash-equivalent value of comparables. Creative deal terms can make a deal more (or less) valuable than it appears on the surface. Here are three common reasons why selling price can be a misleading metric and may require an adjustment to arrive at a cash-equivalent value.

## 1. Installment contracts

In some situations, the buyer may pay the seller a lump sum up front and then make ongoing installment payments over a period of time (usually, three to five years). These deals sometimes require interest payments, as if the seller is providing financing for the buyer. Other times, the interest rate is wrapped up in the installment payments and can be imputed based on market rates.

Installment contracts are particularly common among small businesses when a shareholder is settling his or her divorce — or when a controlling shareholder is buying out a minority shareholder. Typically, installment sales are used to finance deals when the buyer has limited cash and access to bank

## Bridging the gap

Creative deal structures — such as installment payments, earnouts and contractual provisions — often come in handy when there’s a big difference between the seller’s asking price and the buyer’s offer price. For example, suppose a seller is asking for \$10 million, but a buyer thinks the business is worth only \$8.5 million. Can the parties work out their 15% difference of opinion?

This hypothetical scenario was worked out with some creative planning. First, the buyer’s valuation expert suggested that the parties could structure the transaction as a stock deal, which worked to the seller’s advantage from a tax perspective, because the seller’s proceeds are generally taxed at the lower long-term capital gains rate.

Then, the seller’s valuation professional recommended an earnout provision to help reduce the risk that the company wouldn’t reach its cash flow projections. If the buyer would pay 65% of the selling price upfront (\$6.5 million), the seller would accept the remainder (\$3.5 million) over five years. Moreover, the remainder would only be paid on a sliding scale based on whether the company met predetermined revenue benchmarks over the earnout period. No interest would be paid during the earnout period, and the seller agreed to sign a seven-year noncompete agreement.

As a result of these bilateral concessions, the buyer and seller were able to break their deadlock. And they agreed on a creative deal that served the needs of both parties.

loans, possibly due to weak credit, high leverage or insufficient personal assets to guarantee a loan. Here, the seller bears additional risk, because there's a chance that the buyer may be unable to make timely installment payments.

## 2. Earnouts

Likewise, a buyer who's skeptical of management's estimates of future earnings may hedge its risk with "earnout" payments. With an earnout, the buyer pays a lump sum down payment, and then the remainder is contingent on the company's future performance.

The seller may receive the rest of the selling price if certain benchmarks are reached. These benchmarks could include future revenues, market share or cost synergies. Or the seller may opt to receive a set percentage of, say, the company's gross receipts or net cash flow for a certain number of years.

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These provisions can get complicated, so it's important to define financial terms, payout limits and timing issues upfront. The use of an outside accounting firm can help ensure unbiased financial reporting under U.S. Generally Accepted Accounting Principles (GAAP).

## 3. Contractual agreements with sellers

Buyers and sellers may enter into a variety of contractual agreements, including



noncompetes, consulting agreements and employment contracts. These may, for example, protect the buyer from competition by the seller (for a specific number of years) or ease the transition from the seller's management style to the buyer's style.

Sometimes, these contracts are excluded from the selling prices that are reported in transaction databases. But in other cases, pieces of a deal are bundled together, and the valuation professional must allocate value to each component of the selling price in order to achieve apples-to-apples comparisons. In some industries, however, a noncompete agreement may be standard, and can't realistically be separated from the selling price.

### A need for adjustment

The guideline M&A method has intuitive appeal, because it's based on real-life transactions. But experienced valuation professionals know better than to blindly accept comparable deals from transaction databases at face value. It's critical to understand each deal that's being used as a comparable. Often, "selling price" includes creative deal structures that may require adjustments. For help understanding how this method works, contact a credentialed valuation expert. ■



# See for yourself

Site visits are a critical part of the valuation process

Why do you need to see a business to value it? Financial statements, tax returns and marketing materials tell only part of the story. And a written questionnaire doesn't adequately bridge the gap, especially in an adversarial situation. To get a comprehensive understanding of how a business runs, the expert usually needs to see it — and talk to management — firsthand. Here's why site visits are critical when valuing a business, particularly in divorces and shareholder disputes.

## Revealing new information

In some situations, a site visit may help uncover hidden assets or fraud that might have gone undetected if the expert had just relied on information shared by the controlling shareholder from afar. Consider valuation expert "Pat," who's been hired to value a manufacturing company that's buying out an unhappy minority shareholder — who's also unhappy with the buyout offer.



The controlling shareholders initially refused to allow Pat to conduct a site visit. So, the attorney ("Chris") was forced to file a court order to allow Pat access to the company's facility. While waiting in the company's lobby, Pat gathers information from newspaper articles posted on the walls, which she subsequently reports to Chris. These facts include the grand opening of an affiliated company in a nearby town.

During the site visit, Pat notes that the employees seem nervous and avoid making eye contact. Further investigation reveals unrecorded loans to the affiliated company and a shift of several large customers' income from the old to the new plant. What's more, the old plant is paying exorbitant management fees to the new affiliate. These discoveries increased the company's value by nearly three-quarters of a million dollars — and they would have gone undetected if not for Pat's diligence during the court-ordered site visit.

## Thinking beyond fraud

Is a site visit still needed if there's no risk that a controlling shareholder is skewing the financial results? Site visits provide insight into business operations, even when a valuation isn't prepared for litigation purposes. They may shed light on information that's not obvious by reviewing the financial statements.

For example, a valuation professional might notice nonoperating, idle, damaged or obsolete equipment or inventory while touring a facility, as well as inventory and fixed assets without physical asset controls. A production line or warehouse may appear disorganized or unsafe. Employees may even seem disgruntled or overly stressed, suggesting that the company is growing too quickly, human resource issues abound or labor union problems could be impending.

## Meeting with employees

If a valuation expert hasn't previously toured your company's facilities, expect him or her to request a site visit soon after being hired. Before showing up, most experts perform a preliminary review of the company's financial statements and other relevant documents to ensure efficiency and customize interview questions. They also may send a written questionnaire in advance to help management prepare.

Depending on the size of the company and the engagement's confidentiality requirements, the valuation expert will want to talk to several individuals. A side benefit of these face-to-face interviews is that the valuation expert will establish a positive working relationship with employees, which facilitates the valuation process.

Interviews typically cover a broad range of subjects, including but not limited to:

- Operations history,
- Management quality and compensation,
- Hiring practices,

- Technology,
- Marketing and sales programs,
- Methods of distribution,
- Condition of fixed assets,
- Historical financial performance,
- Accounting methods, and
- Internal controls.

Valuations are driven by *future* cash flow projections. So, expect questions about the company's future strategic plans during management interviews. Some business owners may be leery about providing this information, because they don't want it to be leaked to competitors.

## Concluding with a catchall

Many valuation professionals end their interviews with a broad question, such as, "In your opinion, is there anything else about the business we haven't discussed that could potentially affect its value?" Such a question minimizes the danger that management will withhold information or a valuation expert will overlook a key fact. ■

# Court increases dissenters' buyout offer by more than 25%

When computer maker Dell decided to delist in 2013, its board agreed to buy out dissenting shareholders for \$13.75 per share. The dissenters argued that the buyout price was unfair — and the Delaware Chancery Court recently agreed, valuing the stock at \$17.62 per share. *In Re: Appraisal of Dell Inc.* is a high-profile decision that could potentially add millions of dollars to the cost of Dell's management buyout.

## Dissension in the ranks

Dell was a leader in the competitive personal computer market during the 1980s and 1990s. But the company struggled after its founder Michael Dell left the helm in 2004. Around that time, competitors began offering PCs at lower prices than Dell, and new technology (such as smartphones, tablets and cloud-based storage services) emerged, threatening the company's market share.

Michael Dell rejoined the company in 2007 and attempted to turn around Dell's mounting financial distress. In late 2012, Michael Dell proposed a management buyout, because he felt that the public markets didn't appreciate the company's new strategic direction and were preventing it from achieving its long-term value potential.

After considering several third-party leveraged buyout offers and Dell's volatile financial results, the board approved a management buyout for \$13.75 per share. This represented a premium of approximately 38% over the company's 90-day-average unaffected trading price of \$9.97 and about 26% over its one-day average unaffected trading price of \$10.88.

A group of dissenting shareholders filed an appraisal rights suit, alleging that the buyout price was unfair. Both sides hired business valuation experts to determine the fair value of the stock under Delaware law. Courts generally equate this standard of value to the shareholder's proportionate interest in the company's going concern on the date of the transaction to which the shareholder dissents.

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### **Stock price vs. fair value**

Both valuation experts used the discounted cash flow method to value Dell's stock. But their opinions varied significantly: The dissenting shareholders' expert valued the stock at \$28.61 per share, and Dell's expert valued it at \$12.68 per share.

One reason for the discrepancy was the valuation gap between the stock's trading price and the operative reality of the company, which hadn't yet begun to generate the anticipated



benefits of management's long-term turn-around strategy. The court opinion states, "The optimal time to take a company private is after it has made significant long-term investments, but before those investments have started to pay off and market participants have begun to incorporate those benefits into the price of the Company's stock."

Another major reason for the discrepancy between the experts' opinions was how they factored income taxes into their analyses. The dissenting shareholders' expert applied a 21% tax rate, based on projections given to potential buyers and valuation models prepared by the company's financial advisors. Dell's expert used a 17.8% tax rate through fiscal year 2022, and thereafter applied a marginal tax rate of about 35.8%.

The court noted that this marginal rate was significantly higher than the rate Dell had historically paid. The court also ruled that the adjustments Dell's expert made for a deferred foreign tax liability and unrecognized tax benefits were "excessive."

### **An inefficient market**

In the end, the court cherry-picked from both experts' discounted cash flow analyses to arrive at a fair value of \$17.62 per share, an increase of about 28% from the original buyout price. This case highlights how two credentialed valuation professionals can arrive at widely divergent opinions — and how stock price may sometimes differ from fair value in appraisal rights cases. ■

# Using a “yardstick” to measure damages

The yardstick method is a tried-and-true way to measure economic damages in contract breach, patent infringement and other tort claims. In a nutshell, it’s based on comparisons with similar businesses. Here are some additional details on how this method works — and when it might *not* work as well.

## Find guideline companies

In damages cases, financial experts are hired to help the court estimate what a plaintiff might have earned “but for” the defendant’s alleged wrongdoing. In order to withstand scrutiny, experts must base their estimates on real-world evidence, rather than pure speculation.



The market data that’s used in the yardstick method is the performance of similar “guideline” companies during the damage period. In other words, an expert compares the plaintiff’s actual performance with the results it could reasonably

have anticipated “but for” the defendant’s wrongdoing, based on the performance of other companies in the same industry. In addition to lost revenues, it’s important to consider savings from expense reductions when estimating damages.

There are two ways to validate yardstick earnings. First, the expert should establish that the plaintiff’s past performance paralleled that of the guideline companies. Additionally, it’s important to demonstrate that the guideline companies are similar enough to be considered comparable, which may be problematic with smaller companies.

## Understand the limits

Although many courts give significant weight to the yardstick method, it may be subject to limitations. For example, it’s generally not used for start-ups that haven’t produced financial results that are comparable to more-established industry participants.

It’s also important to look at more than industry classification codes when selecting guideline companies. Reliable yardsticks may also be comparable in terms of:

- Market share,
- Target market,
- Financial performance (for example, leverage, asset management and profitability),
- Product and service offerings,
- Marketing strategy, and
- Geographic location.

A weak sample of guideline companies doesn’t necessarily render an expert’s yardstick analysis inadmissible, especially if there’s no direct evidence of lost business. But weak comparables can reduce the value of the yardstick method in establishing economic damages, causing the court to give it less weight than other methods of estimating economic damages.

## Explain the assumptions

Plaintiffs rarely have the luxury of using *direct* evidence to show how much business was lost from a defendant’s alleged wrongdoing. When using an *indirect* method — like the yardstick method — to estimate damages, it’s important to ensure that your expert’s assumptions are supportable — and to give your expert an opportunity to explain his or her reasoning to the court. ■





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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.