

Viewpoint on Value



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A valuator's
insight into
buy-sell agreements

Will your deal fall through?
Avoiding M&A pitfalls

Sanity check
**When to use the
excess earnings method**

The benefits of
collaborative divorce

A valuator's insight into buy-sell agreements

Operating a business without a valid buy-sell agreement is like driving a car without insurance. Buy-sell agreements provide much-needed protection when an owner involuntarily leaves — or voluntarily wants out of the business. A comprehensive agreement not only defines the term “value,” but it also incorporates buyout terms and includes provisions for various buy/sell scenarios and contingencies.

What's it worth?

Every owner wants to get a fair price for his or her business investment. But private firm market prices aren't usually published. A professional appraisal provides an objective estimate of what a business interest is worth in today's marketplace, based on public market data, private transaction databases and an analysis of the subject company's performance.

A buy-sell agreement provides a succinct definition of value, including the:

- Effective date (termination date or date of legal filing),
- Standard of value (fair market value, fair value or strategic value), and
- The interest being valued (minority, nonmarketable or controlling interest).

When choosing the appropriate standard of value, the valuator considers how the appraisal will be used. For example, fair market value traditionally is used in tax situations and fair value may be statutorily defined. To avoid future problems, the appraiser takes into account any legal precedent associated with the chosen standard of value.

The definition of value also may vary depending on the triggering event, the business's ownership composition and the agreement's provisions. For example, if

a 2% owner initiates a buyout, it might be appropriate to value his or her interest on the offer date on a minority, nonmarketable basis. Conversely, if a 60% owner dies, a controlling (undiscounted) value might be appropriate, effective on the date of death.

What are the terms?

Although envisioning exactly how a buyout will happen is a difficult-to-impossible task, business owners should attempt to visualize the most likely scenarios. Shareholders need to decide between the options of receiving one lump sum or taking installment payments



Fund buyouts with key-person insurance

Insurance policies give business owners breathing room when they need it most — that is, when a key person unexpectedly dies or becomes disabled. But how much coverage and which type of policy are appropriate?

For many businesses, value may have changed in recent years, requiring a coverage update. A business valuation can help owners determine how much their interests are worth in the current marketplace.

When buying a policy, owners need to think beyond shareholder buyouts. Key-person insurance also might provide funds to bridge a temporary drop in sales after a key person leaves. Or it might fund the costs of finding and training a replacement.

with a prescribed interest rate. And some installment payments may be contingent on future earnings.

Owners also need to consider who's funding the buyout. Sometimes the company repurchases shares. Alternatively, shareholders may want to personally buy out an exiting owner's interest.

A “Texas shootout” provision is another, more creative alternative. To illustrate how this provision works, suppose Tom, a 50/50 owner, wants to initiate a buyout and names a price for his interest in the business. Then Janet, the other owner, decides whether to buy or be bought out at that price. In this scenario, Tom shouldn't lowball his partner Janet — or he'll risk being underpaid for his investment. Conversely, if he overvalues the interest, Janet will receive a windfall.

Tax obligations can affect deal structure, but there are personal considerations, as well. For example, does the owner want the deceased's family involved in future business operations? Is he or she planning to sell the business before an installment term expires? In all of these scenarios, the owner should carefully discuss financial and personal goals with an appraiser before an unexpected event occurs.

What about the appraisal?

A thorough buy-sell agreement outlines the process of obtaining appraisal expertise. Some agreements call for both sides to retain separate experts and for a third appraiser to resolve any discrepancies. Others may opt for a single, unbiased valuator. Some buy-sell agreements may even specify an individual appraiser or a valuation firm in order to save time later on when the buy-sell is triggered.

Consider, too, the appraisal timeline and who pays appraisal fees. Typically, appraisal fees are paid by the individual owner in a voluntary transfer or dispute, or by the company in an involuntary transfer, such as when an owner dies or becomes disabled.

Rather than wait for a triggering event to occur, some buy-sell agreements call for periodic appraisal updates. This ensures everyone remains on the same page — and minimizes potential conflicts.

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Is it valid?

A buy-sell agreement may not stand up in court if the owners fail to follow its provisions when buying out retirees or adding new ones. If ownership changes, a valid buy-sell agreement becomes the touchstone that everyone adheres to. Therefore, it should be updated on a regular basis to ensure it contains accurate terminology and desirable buyout terms.

Ownership changes needn't force a business into crisis mode. With careful planning and attention to detail, a buy-sell agreement can be a valuable tool. The more details a buy-sell agreement spells out during normal business conditions, the fewer surprises a company will encounter when an owner leaves. ●

Will your deal fall through?

Avoiding M&A pitfalls

Buying or merging with another company to increase market share, compensate for operational weaknesses or acquire talented workers in scarce labor markets may seem like a no-brainer. But despite how great the deal looks on paper, many mergers and acquisitions (M&As) fall through because they simply don't make sound financial sense. A valuator can help businesses avoid making a major M&A mistake.

The rule-of-thumb pitfall

Unfortunately, M&A participants often rely on industry “rules of thumb” and gut instinct, especially in mature industries. Although rules of thumb can provide a reasonable basis for initial M&A discussions, they fail to address important valuation considerations, such as nonoperating assets and changes in market conditions. Therefore, they're rarely sufficient as the sole basis for a deal.

Before making a formal offer to merge with or acquire another business, management should obtain a thorough valuation analysis — one in which the valuator considers *all* three valuation approaches — cost, market and income — before selecting the most appropriate approach to arrive at a reasonable purchase price.

The overpayment pitfall

Regardless of the industry or geographic location, several factors may cause a buyer to overpay, thus causing the merger or acquisition to fall short of expectations. For instance, there may be inaccurate assumptions as well as a lack of astute due diligence. A purchase price is only as reasonable

as its underlying assumptions. In many cases, buyers forecast unrealistic synergies and economies of scale. Others mistakenly believe they can run the business more efficiently than the previous owner.

Similarly, the buyer may analyze a transaction using unsupported hurdle rates (benchmarks used to evaluate investment decisions). Generally, the hurdle rate should be commensurate with the purchaser's cost of capital.



When a buyer uses a hurdle rate below its cost of capital, it's more likely to overpay.

In addition, industrywide consolidation can sometimes lead to inflated pricing multiples. In some cases, valuation multiples may become detached from economic reality. In the midst of frenetic M&A activity, management may feel compelled to pay overly high acquisition premiums to maintain sufficient market share.

Overpayment consequences

When companies overpay in a merger or an acquisition, the results can have a ripple effect throughout the organization. In some cases, ill-conceived deals can even lead to bankruptcy.

Of course, this is a rather extreme example of the consequences of overpayment. Most companies don't close their doors just because of one bad deal. More common consequences of overpayment include reduced shareholder value and deteriorated financial ratios.

In many cases, buyers forecast unrealistic synergies and economies of scale.

For instance, when a buyer overpays for a business, the cash and stock exchanged plus the additional debt load is greater than the present value of incremental future earnings. In mergers, overpayment dilutes the shareholders' ownership percentage in the new entity. These value decrements usually aren't reflected on the buyer's balance sheet.

And when a deal subsequently fails to meet expectations, it can adversely affect a buyer's financial ratios, including profitability, liquidity and leverage metrics. Weaker ratios raise a red flag to commercial lenders and investors. In some cases, financial ratios may fall below the benchmarks set forth in the companies' loan covenants, leading to default. In others, lenders



and investors will require a higher return, thereby increasing the company's cost of capital.

Due diligence is key

Due diligence refers to the systematic process of evaluating a proposed deal. Comprehensive due diligence addresses financial, operational, technology and human resource issues. Beyond looking at financial statements and tax returns, buyers should perform site visits and interview personnel, customers and suppliers if possible.

When due diligence is performed too hastily or its scope is too narrow, buyers are likely to overlook deal-threatening risk factors, such as contingent liabilities, obsolete assets, concentration risks, poor internal controls, unpaid taxes or employee retention problems.

Problems and risk factors unearthed through acquisition due diligence should be investigated and reconciled. In some cases, the buyer may need to negotiate the deal's terms. For example, to offset the risk of a significant contingent liability, the buyer may reduce the purchase price or negotiate a seller-funded escrow account.

The best defense

Clearly, the best defense against M&A failure is thorough due diligence. Valuation experts are well suited to help acquisitive companies and their attorneys evaluate M&A transactions. As objective outsiders, they can evaluate whether a deal will work in the real world. ●

Sanity check

When to use the excess earnings method

The IRS developed the excess earnings (or formula) method in the 1920s as a way to compensate breweries and distilleries for intangible value lost during the Prohibition era. Surprisingly, appraisers still use this method to value businesses in a variety of industries.

Although the excess earnings method may *appear* simple, it's actually both ambiguous and subjective. In fact, IRS Revenue Ruling 68-609 states that this method should be used only "if no better evidence is available."

Understand the mechanics

Today, the excess earnings method is sometimes applied in family court or tax cases, especially for small professional practices. Following is an example of how the excess earnings method worked for the ABC Company.

ABC Company (as of Dec. 31, 2010)	
Net tangible asset value	\$1,000,000
Normalized earnings	\$400,000
Return on tangible assets (\$1,000,000 × 10%)	<u>(\$100,000)</u>
Excess earnings	\$300,000
Value of intangibles (\$300,000 ÷ 20%)	<u>\$1,500,000</u>
Value of ABC Company	<u>\$2,500,000</u>

In a nutshell, the method assumes that a business earns a return on its tangible assets. In the example, we've assumed a 10% return on tangible assets. Although there's no empirical data available for estimating the rate of return, the IRS ruling suggests a range from 8% to 10%, depending on business risk.

The valuator then attributes any earnings exceeding the tangible asset rate of return to goodwill and other intangible assets. Excess earnings are capitalized at a rate commensurate with the expected rate of return



on intangible assets, which is usually higher than the return on tangible assets. The IRS ruling suggests a range from 15% to 20% for the return on intangibles. (The example here uses 20%.)

Business value equals the sum of net tangible assets and capitalized excess earnings. The valuator adds back any nonoperating assets separately. In addition, the valuator may subtract debt if analyzing invested capital earnings.

As the example shows, the valuator may use the value derived from the excess earnings method to impute an overall capitalization rate. He or she may compare this rate to rates of return used in the income approach, and compare the inverse to the pricing multiple used in the market approach.

Beware of pitfalls

Critics of the excess earnings method argue that it's outdated, and its theoretical foundation is insubstantial. For example, it's unclear what's meant by the term "earnings." A valuator might use pretax earnings; earnings before interest, taxes, depreciation and amortization; or net free cash flow. While a valuator may use a weighted average of the last five years' earnings, value should be a function of future (not historic) earnings.

In addition, a valuator may rely on book value to approximate net tangible assets' value — but book value is based on historic cost. Valuators must remember that fixed assets also may be subject to accelerated tax depreciation schedules, and receivables may require adjustments for write-offs.

And it's important to note the subjectivity involved with quantifying the expected returns on tangible and intangible assets. A small change in the rate of return can have a significant impact on value. In our example, if a valuator used 15% as the expected rate of return on intangible assets, ABC Company's intangibles would have been worth \$2 million — an increase of \$500,000 — or 33% over the original value of \$1.5 million.

Respect its limits

The excess earnings method is common — but controversial. It's important to know where the excess earnings method falls in today's valuation hierarchy. Although rarely used as a sole method of valuation, excess earnings may provide a sanity check for other methods — or it may provide a means of separating out intangible value from the value of net tangible assets. ●

The benefits of collaborative divorce

Marital dissolutions can get ugly and expensive, but they needn't be. Collaborative divorce has emerged as a way to split up marital estates amicably and creatively, all the while minimizing professional fees and court costs. This approach is not just for small estates either — wealthy couples actually stand to lose more if settlement is left to the court's discretion.

In collaborative divorce, the parties contractually agree to settle their breakup out of court and to openly exchange all relevant financial information. Each side hires his or her own attorney — then the parties meet regularly to brainstorm settlement options. The only court appearance occurs when the attorneys present their final settlement agreement to the judge.

Why does collaborative divorce save time and money — especially for larger marital estates with complicated settlement considerations? Simple — it requires only one neutral financial expert.

For example, suppose the wife owns a private business interest. In a traditional divorce case, two experts would be hired and educated about how the business operates. Each expert would prepare an independent appraisal of the business. This process is time consuming and may disrupt normal business operations. In addition, two experts rarely arrive at exactly the same value conclusion, requiring them to rebut each other's report and reconcile the differences.

But with one expert, these problems are eliminated. And beyond providing appraisal expertise, the financial expert can help divorcing spouses with many other issues, such as alimony and child support payment options, equitable asset and debt allocations, and postdivorce budgets and tax preparation.

True, collaborative divorce isn't for everybody. Trust and honesty are key prerequisites. But those who successfully collaborate stand to benefit: The goals are to maximize the "pie" *before* slicing it up — and to minimize hard feelings. The latter is especially important when the parties intend to co-parent or jointly operate a business after the dust settles.

