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Valuation Report

Business Valuation Trends and Strategies

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Planning Ahead

Best Valuation Practices for Buy-Sell Agreements

What's the best valuation method for a buy-sell agreement? This question is the subject of much debate among business owners, valuation analysts and financial advisors.

Everyone agrees that fairness is the goal. But how can fairness be achieved with so many variables affecting the value of the company from day to day and year to year? Moreover, what's really "fair"?

Critical Choices

A buy-sell agreement dictates what will happen when a partner or shareholder retires, dies, becomes disabled or leaves the company for some other reason. The agreement describes the arrangements of an owner buyout, including purchase pricing, funding and payment terms.

Having a buy-sell agreement in place takes the emotion out of the discussion when a partner leaves. The agreement minimizes the possibility that shares can be sold or left to individuals or businesses that might create an undesirable or untenable partnership for the remaining shareholders.

But what the buy-sell agreement hinges on is value. This is why the valuation provision is one of the most critical aspects of a buy-sell agreement. How much is the departing shareholder's piece of the company worth?

Types of Provisions

Buy-sell agreements typically include one of three types of pricing mechanisms: fixed price, formula and valuation. Most financial advisors agree that a fixed price is unworkable because the price is out of date as soon as it's fixed.

Formulas are more flexible and are designed to reflect a current price based on current inputs at the time of the triggering event. The challenge with this methodology is agreeing on the various inputs and the nuances thereof. For example, if net income is the basis for calculation, then how, by what and over what duration is net income adjusted? Unless the buy-sell agreement precisely clarifies the inputs, the document doesn't serve its purpose well.

A valuation appears to be the "fairest" way. But like a formula approach, it begs the question of inputs as well as the standard of value to be used, discounts, valuation date and appraiser.

Proactive Valuation

Z. Christopher Mercer, author of *Buy-Sell Agreements for Baby Boomer Business Owners*, suggests a valuation-based approach he calls "Single Appraiser, Select Now and Value Now." While it has valuation at its core, the approach addresses a number of the questions that typical approaches leave unanswered.

Mercer suggests that the buy-sell agreement name one independent appraiser (or firm) to do the valuation. This is not an unusual provision.

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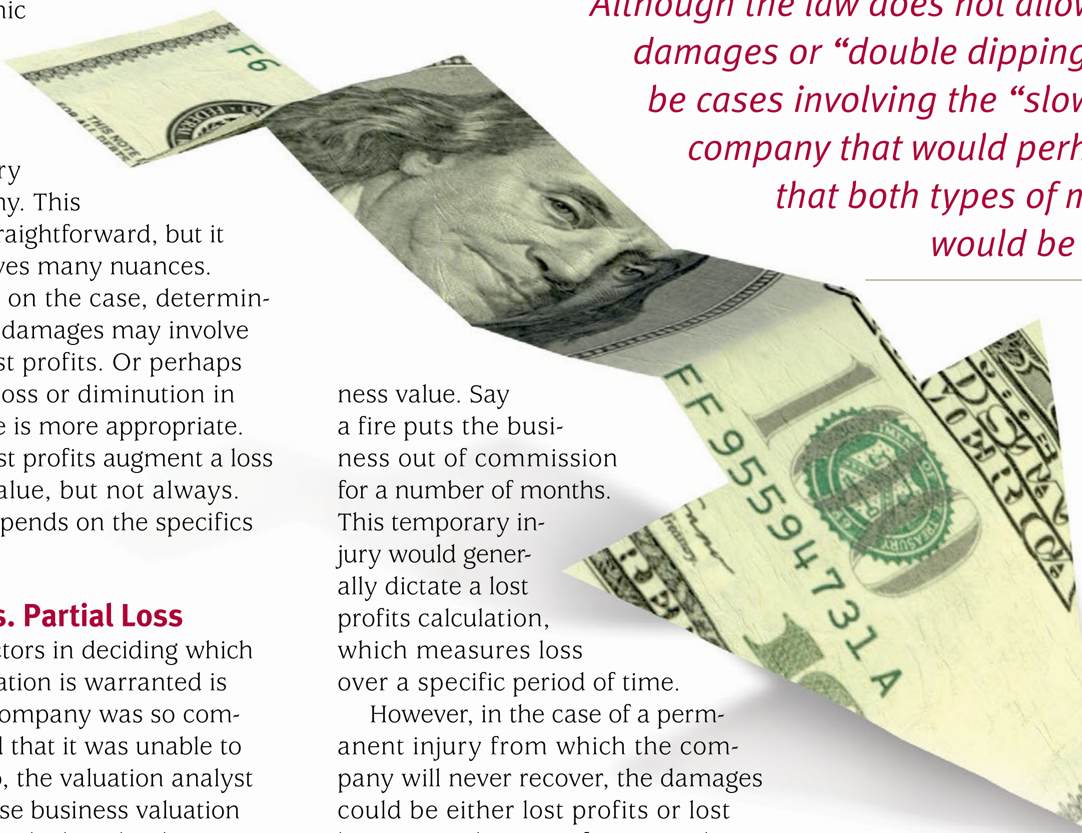
Litigation Topics

Economic Damages: Lost Profits vs. Lost Business

Although the law does not allow duplicative damages or "double dipping," there may be cases involving the "slow death" of a company that would perhaps indicate that both types of measurement would be appropriate.



When calculating economic damages, the objective is to determine the extent of financial injury to the company. This may sound straightforward, but it actually involves many nuances.

Depending on the case, determining economic damages may involve calculating lost profits. Or perhaps calculating a loss or diminution in business value is more appropriate. Sometimes lost profits augment a loss of business value, but not always. Everything depends on the specifics of the case.

Complete vs. Partial Loss

One of the factors in deciding which type of calculation is warranted is whether the company was so completely injured that it was unable to continue. If so, the valuation analyst would likely use business valuation techniques to calculate the damages, measuring the value of the company before the injury when it was thriving, and after the injury when it may only be worth the liquidation value of its assets.

If the company was partially injured and suffered a slowdown but not complete cessation, the injury could cause either a temporary loss of profits or a permanent downturn in business value. Say a fire puts the business out of commission for a number of months. This temporary injury would generally dictate a lost profits calculation, which measures loss over a specific period of time.

However, in the case of a permanent injury from which the company will never recover, the damages could be either lost profits or lost business value. Say, for example, that the actions of a vendor caused a company to permanently lose its biggest client. The company would certainly experience lost profits, but it might also suffer a permanent loss of value due to permanent impairment in future cash flows.

In this case, the valuation analyst must determine if the injury is truly permanent. If so, business valuation techniques may be used instead of lost profit calculation techniques.

Whether lost profits or lost business value, temporary or permanent, the analyst must show that the damages were substantially caused by the injury in question, and that the damages calculated are reasonable.

Double Dipping

Does an injury to a business ever call for a lost profits calculation and a business valuation? Experts disagree.

Although the law does not allow duplicative damages or "double dipping," there may be cases involving the "slow death" of a company that would perhaps indicate that both types of measurement would be appropriate. For example, it may be that a company lost profits for a substantial "interim" period of time when the owner was trying to mitigate the damage before the company ultimately failed.

In such a case, the facts may indicate that the interim period justifies a lost profits calculation. Then a business valuation would reflect the damages once the company stopped being a viable operation.

Facts and Circumstances

Whether lost profits or lost business value, temporary or permanent, the analyst must show that the damages were substantially caused by the injury in question, and that the damages calculated are reasonable.

All valuation analysts agree that their approach to each case depends on its specific facts and circumstances. That's why it is crucial to work with an experienced, credentialed valuation analyst who can support his or her assumptions in court. ■

Measuring damages requires specific expertise. Please call on our firm to assist with these important calculations.

Technical Topics

Determining the Value of Control

In the course of their work, valuation professionals often consider the value of control — or lack thereof — and its effect on the value of equity interests. Majority positions may command a control premium, while minority positions often suffer a discount for lack of control (or a DLOC).

It's no surprise that valuation analysts have differing opinions on how control premia should be used. One highly regarded valuation expert, Aswath Damodaran of NYU's Stern School of Business, makes an interesting argument that current methodology isn't always purely reflective of control. Moreover, he argues that adjusting for the value of control shouldn't be a given for every company.

Database-Derived Numbers

When using control premia to adjust valuations, it's important to understand where they come from. A common tool used by valuation analysts for this purpose is databases containing metrics based on public company transaction data.

Searchable M&A databases like Mergerstat list control premia for transactions specific to various industries, transaction sizes and other factors. The actual premia can vary significantly, but often fall between 20 percent and 50 percent. Using these control premia figures, valuation analysts can calculate DLOCs for target companies. For example, if the control premium was 25 percent for Company X's acquisition, its reciprocal can be calculated as a proxy for the DLOC as follows: 25% / (1+25%) = 20% DLOC.

But Damodaran contends that this entire premise is flawed. First, Damodaran says, database-derived public company control premia actually include and reflect a variety of acquisition motives beyond control, including synergy and (according to Damodaran) overpayment.

Second, he says that when valuing an existing company, public or private, the value reflects the current management of the business, or a "status quo" value. "We can also revalue the company with a hypothetical 'optimal' management team and estimate an optimal value," Damodaran wrote in a whitepaper on the topic. "The difference between the optimal and the status quo values can be considered the value of controlling the business."

Premiums Should Vary

Following this logic, a control premium would be larger for poorly managed firms and smaller for well-managed firms. "In fact," Damodaran says, "the control premium should be zero for firms where management is already making the right decisions."

Damodaran also contends that there can be no simple "rule of thumb" because control premia would vary depending on why a firm is performing badly. For example, performance may be bad because of management missteps — which would be correctable by a new management team — or because of external factors like a sour economy, which would be somewhat beyond the control of a new management team.

Implications of Assumptions

It seems reasonable to accept Damodaran's assumptions that database-derived control premia already reflect a variety of motives behind the acquisition, and that the management of a firm can affect its value.

For valuation analysts and their clients, these assumptions have two implications: First, that DLOCs calculated from database-derived control premia must be adjusted downward to reflect only the "control" element appropriate to the valuation. And second, that a control premium or DLOC may not always be relevant to the company or equity interest being valued. ■

For more information on this or other technical topics, please contact our firm.

Buy-Sell Agreements

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However, Mercer suggests that the chosen analyst conduct the valuation now, and not wait until a triggering event. This initial valuation "tests" the valuation provision in the buy-sell agreement and gives owners a baseline value, which is reappraised every year or every other year to keep the value current.

Mercer identifies several advantages to this approach. The owners know the current value of the company at all times and know precisely how that number is calculated. Any issues regarding interpretation of the valuation provision in the buy-sell agreement are ironed out prior to any triggering events. When the buy-sell agreement is actually triggered, there are no surprises. All parties are confident in its mechanics and resulting outcome.

Each company is different, and every set of partners has unique issues. No matter how peaceful and friendly the current relationship between partners, discussing the buy-sell agreement valuation provision tends to cause anxiety.

For this reason, it's wise to make decisions about the buy-sell agreement while everything is copacetic, everyone's in good health and the business is thriving. Revisiting the valuation provision now can save a lot of heartache — and money — in times of stress. ■

Is your buy-sell agreement up to par? Contact us today to discuss the best approach for your business.

One Neutral Appraiser May Speed Litigation

A growing trend in litigation is using one appraiser for both parties. Here's how it works:

- **Initial meeting:** The first step is usually a meeting with the parties, their attorneys and a neutral appraiser to discuss the scope of work and answer technical questions, such as the standard of value to be used. They'll also review logistics, such as frequency of meetings and methods of allowable communication between the parties and the appraiser.

- **Engagement letter:** The appraiser then drafts an engagement letter detailing purpose and scope, the standard of value, and the type of report that will be delivered. The engagement letter might also set out an agreed-upon approach to potentially controversial issues such as enterprise vs. personal goodwill and discounts for lack of control and marketability. The letter will also identify contacts from each party responsible for providing information, and describe payment arrangements.

- **Fact finding:** All requests for information go to both parties simultaneously. For interviews, both parties and their counsel are present, allowing each to provide perspective and hear exactly what the other says.

- **Report presentation:** At least 60 days before the hearing date, the appraiser furnishes both parties with an overview of the facts and items considered. Feedback from this exercise allows the analyst to determine if all the facts have been considered. The analyst may withhold findings and conclusions until the report is issued, which is typically about 30 days before the hearing date.

- **Hearing:** Because the valuation analyst is neutral, there is no traditional direct cross-examination or redirect of testimony. The appraiser is "cross-examined" by counsel from both parties.

Using one expert is particularly appealing in divorce cases. Without dueling experts, things tend to go more smoothly and economically. ■