HANTZMON WIEBEL LLP
Certified Public Accountants
for over 85 years

Valuation Report

Business Valuation Trends and Strategies

Fall 2016

Litigation Insights

Court Cases Illustrate Key Valuation Concepts

For valuation professionals, there's never a shortage of interesting court cases to learn from. Here are two recent cases that shed light on the key concepts of tax affecting and loss of value.

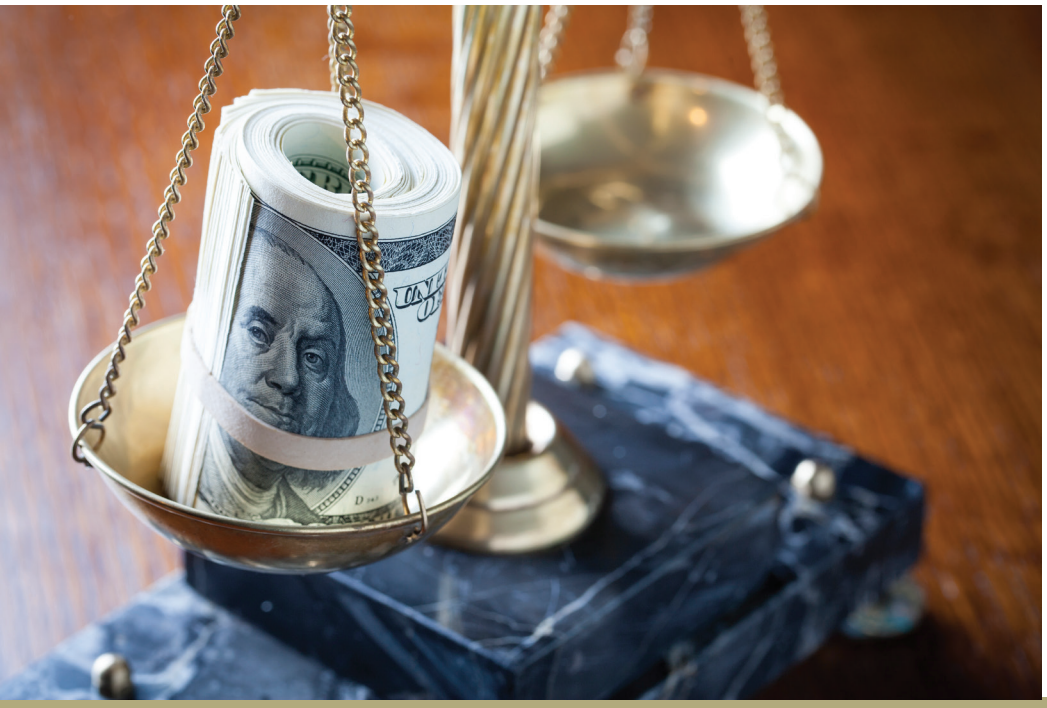
New Ruling on Tax Affecting

In the case of *Owen v. Cannon*, three partners built a successful software company. The plaintiff, the company's president, owned about a third of the company and the defendants owned nearly all the rest.

The company was successful and revenue in the five years prior to the litigation climbed dramatically. A disagreement resulted in the defendants terminating the plaintiff as president. But though he stopped working, he continued to receive his salary, benefits and distributions.

The defendants prepared to buy out the plaintiff and hired a big accounting firm to value the company and help obtain financing. The firm prepared a discounted cash flow (DCF) analysis as part of a series of valuations. In the fall of 2012, the firm valued the plaintiff's share at $25.3 million, excluding cash on hand.

Around this time, the company offered the plaintiff a buyout of $18 million, based on an older (2011) valuation. He rejected this, saying the company was "exploding in growth."



In 2012, the company was about to lose its biggest customer, and new 2013 projections were indeed lower. Based on those numbers, the accounting firm prepared another DCF valuation. The defendants offered the plaintiff $26.3 million, including cash on hand, and went after financing for the buyout based on that number.

The plaintiff never responded to that offer, and the defendants scheduled a special board meeting to vote on a proposed merger that would result in a buyout of the plaintiff. He subsequently filed a complaint with the Delaware Court of Chancery asking for a fair value determination of his shares.

Both sides produced a DCF analysis to value the plaintiff's shares. The plaintiff's expert based her valuation on the 2013 projections. Notably, she tax-affected the company's tax rate to reflect its S status. Her figure: $52.65 million.

Instead of using the 2013 projections, the company's expert created a 10-year set of projections that were significantly lower. He also argued that it was inappropriate to tax-affect the company's earnings. His opinion of the plaintiff's interest's value: $21.5 million.

Rejecting both of these numbers, the court performed its own valuation, noting that most of the gap

Continued on page 3

2 Are Your Projections Put in Context?
3 More on Recent Court Cases
4 Expert Witness vs. Consultant

Word to the Wise

Put Projections in Context

Projections are central to a valuation. They are a key component in identifying the "future benefits" — frequently measured as cash flows — expected to be generated by the business.

But most of the time, projections are delivered by the target company itself. With this in mind, valuation analysts are always aware that they must put projections in a larger context and vet them against the reality of what's going on in the industry, the broad economy and the world. Are the projections on target? If not, why not?

Reality Check

No business exists in a vacuum. There are always forces at work that either buoy or depress a business — sometimes minimally and sometimes to a great degree. Projections that don't deliberately reflect these factors are not truly representative of the company's outlook.

Indeed, IRS Revenue Ruling 59-60, perhaps the most widely cited source of business valuation procedures, requires certain fundamental analysis of the target company in context, including:

- The economic outlook in general and the condition and outlook of the specific industry in particular,
- The earning capacity and dividend-paying capacities of the company, and
- The market price of corporations engaged in the same or similar line of business, having their stocks traded in a free and open market.

Considering these contextual cues lets an analyst assess how they impact the risk reflected in the valuation. In addition, these cues provide insight into how risk-averse investors are in the capital markets, and the market value placed on performance for a company with the same basic characteristics.

A Look Inside and Outside

When the analyst looks at projections and compares them to the general economy or industry, the projections will typically indicate higher or lower growth than the economy or industry at large. The question then becomes, "Why?"

Why is the company projected to grow faster or slower than the economy? The reasons typically fall into one of several categories. For example:

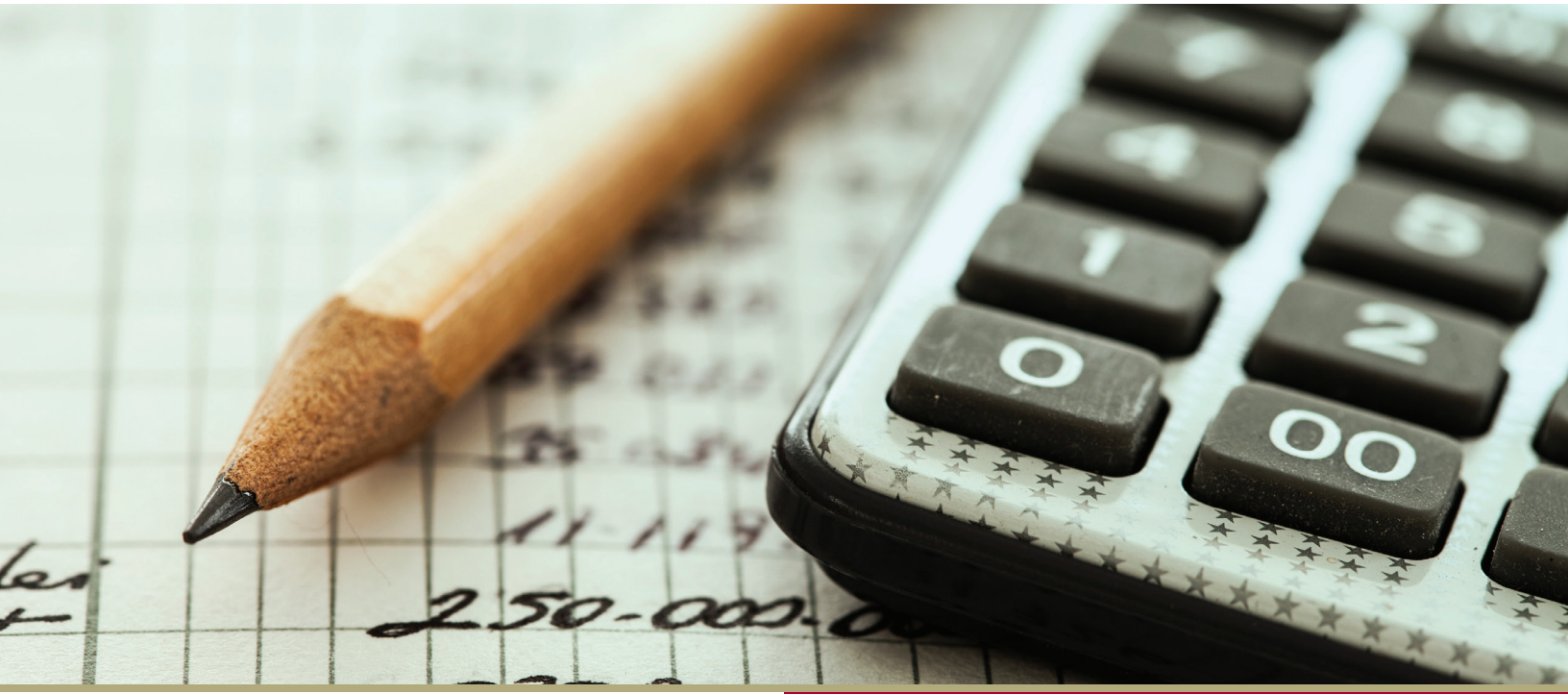
Human resources: How does the company compare to others relative to its human capital?

Intangible assets: How stable and progressive are the company's technology, marketing, customer relationships and contracts? Is the brand strong? Is the sales region robust? Do patents and trade secrets represent a competitive edge or a deficit?

Capital resources: Is the company set up for success relative to plant capacity or space? Does it have the ability to obtain debt or equity funding from capital markets?

Finally, the analyst must look at the company's cost of capital, estimating the cost of debt and equity and the amounts of each used to fund the company. The optimal capital structure is one that maximizes a company's value while minimizing its cost of capital.

All of these measurements are (or should be) reflected in the company's projections. It's crucial that all parties concerned with a valuation recognize the importance of looking at the big picture and putting projections in context. ■



Litigation Insights: A Look at Recent Court Cases

Continued from page 1

between the two numbers was based on disagreement over the projections and tax affecting.

The plaintiff argued that the 2013 projections prepared by the company reflected the best estimate of the company's future. Oddly, the company backed away from its own 2013 valuation, saying that the projections they'd prepared were "not the product of a robust process." In an expansive opinion, the court concluded that there was no sound reason to reject the 2013 projections.

Relative to the tax-affecting question, the plaintiff's expert argued that the plaintiff's interest should be tax affected to capture the denial (due to the proposed merger) of the future benefits of the company's S corp status. The court agreed. Using the model determined by the seminal tax-affecting court case to date, *Kessler*, the court determined a hypothetical corporate tax rate of 22.71% — very close to the initial rate of 21.5% proposed by the plaintiff's expert.

Accounting for a few other disputed inputs, the court valued the plaintiff's shares at $42.16 million.

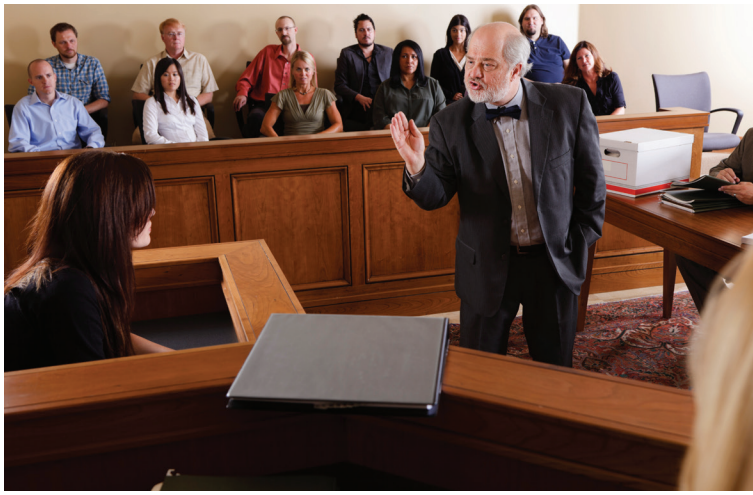
Lesson learned: First, a no-brainer: Don't produce projections for bank financing if you won't later stand by them in court. Second (and perhaps more important), this case is a good one for proponents of tax affecting. It has given many valuation analysts hope that the Delaware Chancery Court's clout will influence more cases in favor of tax affecting.

Loss of Franchise Value

In the case of *TriCounty Wholesale Distributors v. Labatt USA*, two beer distributors had franchise agreements with a number of beer brands, including Labatt. In 2013, Labatt terminated the agreements with the two distributors and agreed to compensate them for the diminished value of the business "directly related to the sale of the brand terminated."

The plaintiffs proposed two ways to determine the diminished value: a DCF analysis applied to the plaintiffs' businesses with and without the brands, and an analysis using comparable transactions.

The plaintiffs' valuation expert concluded that, based on the DCF analysis, for Plaintiff 1 the drop in value was $646,000, and for Plaintiff 2 it was close to $6.1 million. These numbers reflected warehouse, delivery and labor-related cost savings as a result of losing the brands.



The plaintiffs' expert also asked the court to consider comparable transactions based on a gross profit multiple approach. He suggested a multiple of 6x gross profits on the lost brands for Plaintiff 1 and 2.25x on all beer sales for Plaintiff 2.

The defendant's expert produced only a DCF analysis for the value of the lost brands. He said he had intended to value the businesses in their entirety, but that the evidence showed the termination of the franchises would have no noticeable impact on the plaintiffs' other assets. Moreover, he rejected the plaintiffs' comparable transactions argument and disparaged the use of multiples.

The defendant's expert determined that damages for Plaintiff 1 were close to $134,000 and for Plaintiff 2 were approximately $723,000.

The court rejected both experts' approaches. Instead, the court decided to use a "hybrid" approach which involved determining fair market value of the franchise contracts using DCF, then adding in any losses resulting from the agreement termination.

The court found that the defendant's DCF analysis was more credible and straightforward. The court faulted the plaintiffs' expert for not explaining his calculations and charts, which devalued his testimony.

That said, the court modified the defendant's valuation based on assumptions he made about capital structure, cost savings and post-determination benefits. The court also rejected the use of gross multiples, although it eventually adjusted the defendant's DCF analysis in a way that brought it in line with industry average gross multiples.

The court awarded Plaintiff 1 $302,700 and Plaintiff 2 approximately $2.76 million.

Lesson learned: The court didn't really find either expert's conclusions to be credible, but it especially criticized the plaintiffs' expert for not better explaining his approach and conclusions. Ensuring that the court understands your argument is imperative. If not, the court may well find its own "hybrid" path.

Each court case is based on its own specific facts and circumstances. However, examining the ins and outs of valuation cases like these can be illuminating for all parties involved in litigation. ■

Looking for analysts who can defend their work in court? Contact our valuation team to learn how we can help you.

HANTZMON WIEBEL LLP
Certified Public Accountants
PROVIDING SOLUTIONS. CREATING VALUE.

HANTZMONWIEBEL.COM 434.296.2156
818 EAST JEFFERSON STREET CHARLOTTESVILLE, VA 22902

Expert Witness or Consultant: Which Do You Need?

If you are facing litigation that requires a valuation, you will need assistance from a valuation analyst. But how you engage the analyst can make a big difference in both the advice you receive and how you use it.

The question of whether to hire a valuation analyst as an "expert" or a "consultant" may sound like semantics, but the difference is important. Both experts and consultants have specialized knowledge, skills and training in business valuation.

Experts, also known as expert witnesses, are expected to formulate an objective opinion of value and then present that opinion in court. They are not to be advocates for one side. Their work must be disclosed to opposing counsel and is subject to discovery procedures.

A consultant possesses the same qualifications as an expert witness but is typically engaged to give advice to one side before a trial. A consultant does not render an opinion at trial and his or her efforts, opinions and involvement do not have to be disclosed to opposing counsel. Consultants can work completely behind the scenes, not subject to discovery procedures.

It may sound like semantics, but the difference is important.

Why hire one or the other? Working with a consultant, there is no expectation of independence or objectivity, so he or she can offer bold theories and strategy to assist the hiring side. The consultant can play devil's advocate and provide a range of positions for the hiring attorney to try or test. However, if you need an analyst to present and defend a valuation in court, he or she must be hired as an expert.

Either way, hiring expectations and deliverables must be clearly spelled out in the engagement letter. Also, if you eventually choose to "flip" a consultant into an expert, a second engagement letter may be required. ■

Our valuation analysts work as experts and consultants. Contact us to discuss your needs.