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Valuation Report

Business Valuation Trends and Strategies

Winter 2014

Legislative Update

Latest Court Cases Present Provocative Issues

The valuation community is always intrigued by the outcomes of various court cases. Here are a few of note from last year:

In re Eastman Kodak Company

Kodak filed for Chapter 11 bankruptcy in 2012. Shareholders objected to the company's reorganization plan, arguing that Kodak had underestimated its fair market value by more than $2 billion. The shareholders presented two expert reports and other evidence to show that an equity committee was needed to represent their interests. Prior to trial, Kodak filed a *Daubert* motion to exclude most of the evidence presented by the shareholders, claiming that reports of the shareholders' experts were not credible.

The first expert, a recent law school grad with limited valuation experience, had performed a discounted cash flow analysis and concluded that the value of Kodak's U.S. patents was between $1.6 billion and $2.5 billion. Kodak disagreed. The court found the expert's testimony to be lacking, stating, "… he spent only five hours and his firm spent a total of ten hours on valuating Kodak's patents." The court also noted contradictions in his testimony and concluded that his opinion rested on assumptions that had "no validity whatsoever."

The second expert, who testified about brand value, admitted at the hearing that she had been rushed and lacked certain information that might have been helpful. In fact, she and her colleagues had spent what the court characterized as a "grand total of six hours" on the work and submitted her preliminary evaluation at 3 a.m., very late in the game. The court ruled that her valuation was inadmissible based on her admitted "inability to perform an analysis with the same information she would ordinarily use."

Bottom line: The hastily assembled reports and ill-prepared experts lacked credibility. The obvious lack of time and effort spent on the valuations just didn't fly, and the limited value of the company precluded the shareholders from receiving any distribution from the bankruptcy estate.

Tutunikov v. Markov

In 1997, four partners started a business, but the two minority shareholders left to work elsewhere before the business really got going.

Several years later, after finding out that the majority shareholders had given themselves huge raises and made other decisions to their benefit, the two minority shareholders requested that they be bought out. The initial offer from the majority shareholders was $10,000 per share. The minority shareholders rejected that figure and went to court.

Both sides presented valuation experts. The majority shareholders' expert concluded that the business was worth $3.5 million, while the minority shareholders' expert's figure was $35.5 million. The court discredited both valuation opinions as too biased, and turned instead to a third-party investment proposal — done

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Start-up Valuations Require Careful Assessment of Risk

One of the most difficult and nerve-wracking tasks for entrepreneurs is raising capital. While initial seed money for start-ups often comes from friends and family, a formal valuation is required to set the price and attract funding from private equity firms, venture capitalists and angel investors.

Assessing Risk

Remember, valuation is based upon expected returns and associated risks. The higher the risk, the lower the value. Investors must be convinced that those expected returns justify the risk associated with making an investment. Entrepreneurs can increase the amount of investment they attract by helping investors understand the risks facing the business and, more importantly, management's plan to mitigate these risks.

To attract investors, the company must have a viable, comprehensive business plan without major gaps. Below are some of the typical risks analysts encounter as they determine fair market value for a start-up:

- **Management:** Brilliant scientists and computer geniuses may have great ideas, but often lack experience running a business. Sometimes the executive team doesn't get along or has disparate goals for the company. A disjointed group without proven success increases risk.

- **Business strategy:** With little experience on which to base their assumptions, some entrepreneurs make strategic errors that increase risk. For example, product pricing may not be based on appropriate research, or the market potential may have been miscalculated.

- **Product and technology:** Just because the company has created a handsome prototype doesn't mean the product can be manufactured for the mass market at the right price. Plus, it's difficult to ramp up production to ensure a consistent, quality product. Investors want all the kinks worked out of manufacturing and production.

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- **Market:** What is the competitive situation? How is the timing? Is there a ready market for this product or service? Is another company closer to launch? Investors are looking for as "sure" a deal as they can get in terms of market share.

- **Operations:** Equipment and processes must be able to handle incoming orders on time and on budget. The business also needs a trained and efficient workforce.

- **Finances:** The company may be burning too much money too fast and can't keep up with production. Fixed expenses may be too high. The company must be able to run efficiently and effectively within its budget.

Note that in each of these areas, as key milestones are reached, risk is reduced. For example, if the company secures patents, trademarks and copyrights, that's a big step forward in the product and technology arena. The company also needs tight, conservative monthly forecasts for the first two years and a yearly forecast after that. Part of the valuation analyst's job is to challenge the management team's forecast assumptions.

Attracting Investors

Because the risk of failure and loss is so high with a start-up, investors demand a very high rate of return on their money. Interestingly, investors are swayed by other intangible factors as well, according to *Angel Investing: Matching Start-up Funds with Start-up Companies* by Robert J. Robinson and Mark Van Osnabrugge. Both angel investors and venture capitalists rank the enthusiasm and trustworthiness of the entrepreneur, along with the sales potential of the product, very high in importance, the book states.

Placing a value on a new company is a complex endeavor, and it's a moving target as various milestones are reached. Choose an analyst who is experienced in start-up valuations to ensure that the valuation measures the company's true potential. ■

Involved or interested in a start-up? Our firm can help you determine value and strategize next steps.

The Latest Court Cases

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years before — as a "more realistic value" of $5 million. The court augmented that figure by 35 percent, adding back a marketability discount the court believed was contained in the investment proposal, bringing the total value to $6.75 million.

Both sides challenged the trial court's findings on appeal. The majority shareholders argued that the $5 million valuation didn't actually include a minority discount. Rather, they said, the value was really $3.5 million, with the $1.5 million difference representing the investor's willingness to pay for "other" benefits such as a seat on the board and a liquidation preference. Also, they claimed that even if the $5 million value was correct, a marketability discount should have been applied, reducing the value to $3.5 million.

The minority shareholders argued other points. They believed that the trial court's handling of the minority interest was wrong and the court used improper math in applying the investor's offer. Their number: $7.7 million.

The appellate court agreed with the majority shareholders that the investor's price didn't include a minority discount, but neither did it include a premium, as the minority shareholders claimed. The appellate court agreed with the trial court's marketability discount calculation, and agreed with the minority shareholders' contention that the lower court didn't use proper math when applying the discount factor. After all was said and done, the appellate court agreed that the value was $7.7 million.

Bottom line: In a case with dueling experts, it's not a given that one expert's opinion will win. The trial court may come up with a third option, as it did here, and there's no predicting what will happen on appeal.

Wisniewski v. Walsh

Two brothers and a sister each owned one-third of a successful trucking business started by their father in 1952. While the older brother had led the company well for many years, the younger brother stepped up and took over during the older brother's absence to serve time in prison. The sister never worked there, but she sued due to the younger brother's conduct during his leadership tenure, claiming that his misdeeds hurt the company's value.

The younger brother filed an oppressed shareholder action, alleging that his siblings were attempting to force him out. Interestingly, the trial court not only disagreed with the younger brother's claim, it found that he was the oppressing shareholder and ordered him to sell his third back to the company at fair value.

In the second phase of the litigation, the court considered two valuation reports — one from the younger brother's expert and another from the expert hired jointly by the sister and the older brother. The experts were Gary Trugman and Roger Grabowski, two highly regarded professionals in the valuation community. After much back and forth, the court set the fair value of the younger brother's third at $12.4 million. Everyone appealed.

A new valuation was ordered and, five years later, the court set the younger brother's interest at $32 million. Again, everyone appealed. The appellate court found weaknesses in both experts' opinions, and eventually valued the younger brother's interest at more than $32 million. Everyone appealed again.

In the most recent appeal — 18 years after the case began! — the arguments centered on the lower court's use of discounts. The younger brother's expert had used a discounted cash flow analysis, determining the company's value as the present value of its expected future cash flow. The older brother and sister's expert used a market approach, determining value using data from sales of comparable businesses.

In a case with dueling experts, it's not a given that one expert's opinion will win.

The sister and the older brother's estate (he died in 2009) contended that the younger brother's expert calculated a discount rate based on an incorrect equity-to-debt ratio. They also believed that the lower court should have applied a marketability discount.

The younger brother's appeal focused on the fact that the lower court hadn't applied a control premium. He also believed that the court had erred by applying a key person discount for the older brother.

Ultimately, the appellate court upheld the lower court's key person discount rate and agreed that a marketability discount should have been applied. The appellate court disagreed with the younger brother's contention that a control premium should have been applied, and dismissed the younger brother's argument denying the key person discount.

Bottom line: Discounts and premiums are the subject of much debate and litigation. In this case, key man and marketability discounts were appropriate in assessing fair value. ■

If you are interested in learning more about these or other cases, please let us know. Our litigation support team would be happy to discuss them with you.

Source: Business Valuation Update, 2013

Simplified GAAP Proposed for Private Companies

In 2012, the Private Company Council (PCC) was created by the Financial Accounting Foundation to improve the process of setting accounting standards for private companies. Among the PCC's chief responsibilities is to work with the Financial Accounting Standards Board (FASB) to review and propose alternatives within U.S. generally accepted accounting principles (GAAP) to address the needs of private company financial statements.

Goodwill Proposal Finalized

Last July, FASB issued for public comment several PCC proposals that address the relevance and complexity of certain aspects of GAAP for private companies, including accounting for intangible assets acquired in business combinations and goodwill.

In October, the PCC voted to finalize the proposal regarding goodwill that would allow private companies to amortize goodwill on a straight-line basis over 10 years (or less if the entity can demonstrate that another useful life is more appropriate). The proposal would also limit the requirement for goodwill impairment testing to times when a triggering event indicates that the fair value of the entity is below its carrying amount.

The PCC also discussed narrowing the intangible assets acquired in a business combination that private companies would be required to identify and recognize separately from goodwill. The PCC will continue to discuss this proposal after further research by FASB staff.

Awaiting FASB Endorsement

FASB is discussing the proposed alternatives for goodwill accounting, as well as considering their applicability to publicly traded companies and not-for-profit organizations. If FASB endorses the alternatives, they will be issued as final Accounting Standards Updates and would take effect for periods beginning after December 15, 2014. Early application would be permitted. ■

Contact us to discuss how the proposed standards may affect your accounting.