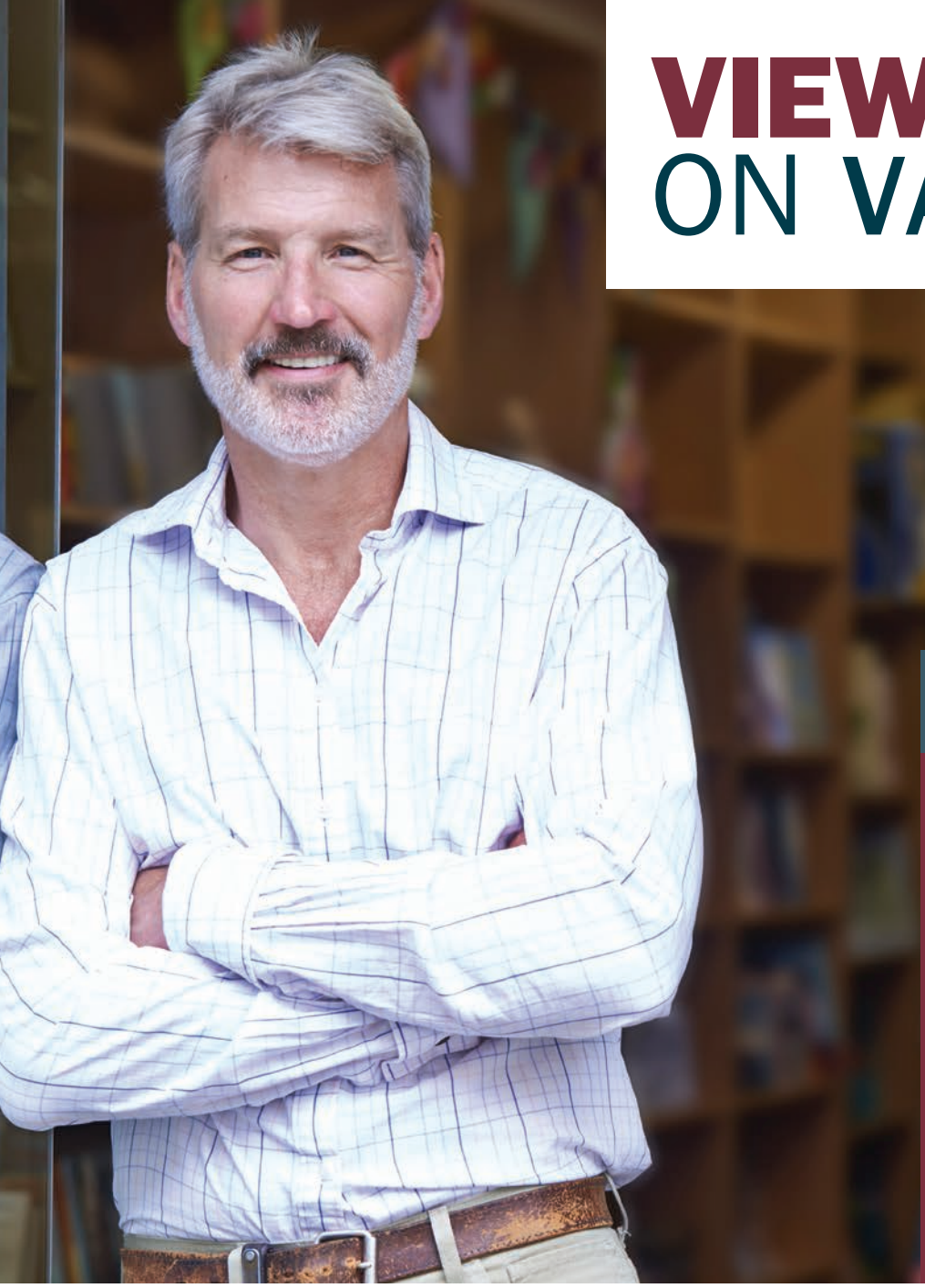

VIEWPOINT ON VALUE

JANUARY/FEBRUARY 2016

Do you have a **Question?** *or want to speak to*

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Retire at your own risk

How to maximize value when exiting a private business

Can you believe that the oldest Baby Boomers (who were born in 1946) will turn 70 this year? Although a lot of younger Boomers continue to be actively involved in the workforce, many older ones who started their own businesses are finally starting to retire. Removing a key person from daily business operations generally isn't something that can be done overnight, however. It takes time to facilitate a seamless transition to new management that also maximizes cash flow to the retiree.

Identify the options

Too often, private business owners presume that their sons or daughters will take over the reins, only to discover that the next generation isn't qualified (or interested) in running the show. Or the next generation might believe that they'll be given a sweetheart deal — while retiring parents expect their children to pay fair market value for the business. Preventing these types of misunderstandings requires owners to have heart-to-heart conversations with heirs about future plans.

When those plans simply don't jibe, it may be time to consider an alternative strategy, such as:

Strategic sale to an unrelated third party. Competitors, suppliers and customers may be willing to purchase the business for a premium due to cross-selling opportunities and economies of scale. Selling to a third party can be a win-win for everyone. In addition to providing cash flow in retirement, sellers will enjoy the comforts of knowing that 1) their legacies will continue to prosper and 2) loyal employees will continue to have a place to work. And heirs will receive cash (and other assets) that can

be used to fund *their* personal interests, rather than settling for their parents' chosen field of interest.

Getting the highest possible selling price may require retirees to sign noncompete agreements or assist with earnouts to minimize risks for the buyers. They may also be asked to enter into consulting agreements to help transition the company to new management. This may require the seller to be of sound body and mind for several more months or even years. So, timing can be critical.

Employee stock ownership plan (ESOP). Sometimes a company's employees are best qualified to take over the business. An ESOP is a type of defined-contribution retirement plan in which employees become owners over time by setting up an employee benefit trust. The current owners typically sell their stock to the trust, effectively creating a "market" for their interests. In turn, the trust usually borrows money to purchase the retiree's stock.

Most ESOPs allow all full-time employees with at least one year of service to participate. Qualifying contributions are a tax-deductible expense for the company. To qualify for such favorable tax treatment, ESOPs can't discriminate in favor of highly compensated employees or owners. Other complex rules and conditions also apply, necessitating the use of legal, employee benefits and valuation advisors.

Liquidation. This option generally doesn't provide as much cash flow as the other alternatives. But liquidation may be the only option if the owner is under duress to exit the business, and the current owner hasn't groomed lower-level managers to operate on their own. In a liquidation scenario, the company closes its doors, sells off its assets (often in an auction), and repays debts, including taxes owed on any gains incurred on asset sales. If time permits, owners may try to boost liquidation proceeds by advertising or approaching competitors about significant assets that are for sale.

Exit strategies aren't just for retirees

Even if retirement is many years down the road, every business owner needs to plan his or her exit strategy. After all, you never know when the unexpected might occur. If you unexpectedly die or become disabled, you don't want to leave loved ones with insufficient cash to survive.

Buy-sell agreements can eliminate the guesswork when tragedy strikes — or when one owner loses interest in the business but the rest are actively engaged. These agreements are formal contracts in which the other shareholders agree to buy out a departing owner's interest. When drafting a buy-sell agreement, it's imperative to work closely with a valuation professional to ensure that all the buyout terms are spelled out in advance. Some buy-sells even call for regular valuation updates to ensure that the shareholders know the current value of the business.

Understand business value

Value is in the eye of the beholder. Retiring owners often have unrealistic expectations about how much their businesses are worth. Likewise, potential buyers may attempt to lowball sellers, especially if they seem desperate to sell due to health issues, cash flow needs or other personal circumstances.

An appraisal can help the parties project future cash flows, identify comparable transactions and conduct due diligence. Such guidance is particularly important to an owner who's cashing in an interest and using it as a "nest egg" to pay expenses during retirement. If they're engaged early on, valuators can even help retirees drive the value higher through strategic planning. ■

Owen v. Cannon

Delaware Court narrows valuation gap

Appraisal issues took center stage in a recent dissenting shareholder case. In addition to addressing the concept of "tax affecting," the Delaware Chancery Court also dealt with several other issues that resulted in a valuation discrepancy of roughly $32 million on the cash buyout of a minority owner.

Background

The central issue in this case was the fair value of Energy Services Group (ESG), an S corporation that provided services to the retail energy industry. ESG's revenue grew at a compound annual rate of 23.4% from 2005 to 2012. Historically, ESG made substantial pro rata distributions of its income to shareholders and typically retained any undistributed income in its bank accounts.

Gradually, relations between the three main shareholders soured. On May 6, 2013, after several failed attempts at mediation, two minority shareholders joined forces to orchestrate a short-form merger that cashed out the company's largest shareholder for $19.95 per share (or $26.334 million for 1.32 million shares). The dissenting shareholder subsequently filed a statutory appraisal claim under Delaware law.

Divergent values

Both sides' appraisers used the discounted cash flow (DCF) method to value the shareholder's minority interest in ESG. Under this method, an appraiser estimates the values of future cash flows for a discrete period. Then, the entity's "terminal value" after the end of the discrete period is estimated, typically using a perpetual growth model on expected future cash flows. Finally, the value of the cash flows for the discrete period and the terminal value are discounted back to their net present value.

But the DCF method is only as reliable as its underlying assumptions. So, the court addressed five questions regarding the proper inputs when valuing ESG:

1. Which projections should be used to determine fair value on the merger date?
2. Should ESG's earnings be tax affected?
3. What growth rate should be used in the terminal period?
4. How much excess cash was on ESG's balance sheet?
5. What percentage of the business did the dissenting shareholder own?

The plaintiff believed his interest was worth approximately $53.46 million in total. The remaining shareholders argued at trial that the interest was worth no more than $21.502 million. Most of the differential between the two appraisals relates to the first two issues.

A critical component of what was taken from the dissenting shareholder in this case was the tax advantage of owning stock in an S corporation.

Cash flow projections

The buyout price was based on five-year projections prepared by management in 2013. At trial, the defendants' valuator relied on a revised set of 10-year projections that were created in the midst of this litigation and based on "pessimistic assumptions."

The court decided to use the original 2013 projections because they reflected

"management's best estimate of what was known or knowable about ESG's future performance on the merger date." Moreover, management was experienced in creating financial projections and used the original projections to secure financing for the buyout.

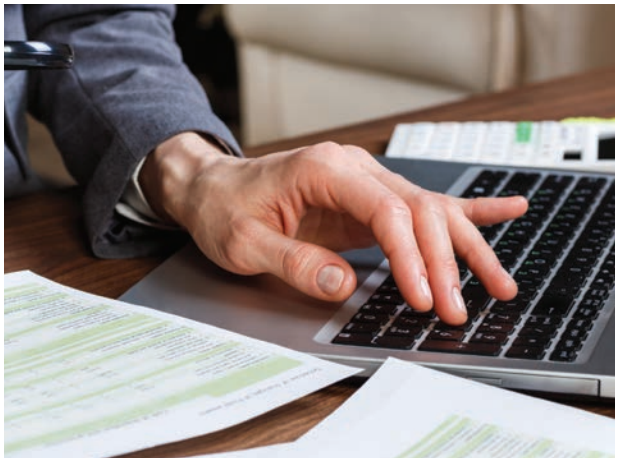
Tax affecting

Under Delaware law, dissenting shareholders are "entitled to be paid for that which has been taken from [them]." A critical component of what was taken from the dissenting shareholder in this case was the tax advantage of owning stock in an S corporation.

The court concluded that it was appropriate to tax affect ESG's earnings at a hypothetical corporate tax rate that treats the dissenting shareholder "as receiving the full benefit of untaxed dividends, by equating his after-tax return to the after-dividend return to a C corporation shareholder." In this case, the court settled on a 22.71% tax rate to apply to ESG's earnings.

Additional lessons learned

In response to the other questions: The court used a 3% growth rate in the terminal period to provide a slight premium over the expected inflation rate. It allocated ESG's excess cash on a pro rata basis after making adjustments



for future tax obligations and working capital requirements. And, last, it determined that the dissenting shareholder owned only 33.85% of the stock after taking into account "performance units" granted to other ESG employees. Based on these assumptions, the court concluded that the fair value of the interest was approximately $42.17 million on the merger date.

Another interesting takeaway from this case was the court's preference for the DCF method. Although the dissenter's valuator applied the market approach, the court disregarded it, stating, "The DCF valuation methodology has featured prominently in this Court because it is the approach that merits the greatest confidence within the financial community." ■

Save time and money with rebuttal reports

A defense attorney will often wait until the plaintiff's attorney submits a valuation report. Then, the defense hires its own expert to prepare a "rebuttal report," rather than pay for a separate full-blown valuation report. This strategy can be a cost-effective way to poke holes in the opposing expert's analyses, but rebuttals are only effective when they're detailed and accurate.

Beyond critiquing

A rebuttal report that identifies flaws, weaknesses and mistakes in the opposing expert's report can provide valuable insight. An attorney can use the rebuttal critique to develop his or her own technical cross-examination questions. But if a rebuttal report doesn't revise the original expert's calculations, it probably won't help a judge or jury quantify damages or value a business interest.

In some cases, courts have rejected the rebuttal expert's testimony simply because the expert didn't provide his or her own revised estimates. A rebuttal report that merely criticizes another expert's work without providing an alternative methodology or analysis may be seen as biased and lacking in substance.

Alternatively, both sides might hire one *joint* rebuttal expert when their respective experts arrive at widely divergent conclusions. This third expert can help the court identify sources of the parties' discrepancies, instead of simply splitting the difference between the experts' estimates. In addition, the rebuttal expert can provide authoritative reference materials to help the court work through the issues and achieve accurate conclusions.

Written vs. oral reporting

If a rebuttal expert is going to testify in court, you might wonder whether a written report is necessary. Sometimes it makes sense for a rebuttal expert to provide oral testimony.

Oral-only testimony can save money, because the expert doesn't spend time writing a report — and it also can introduce an element of surprise into the case.

On the other hand, oral testimony about complex financial matters can be difficult for laypeople to understand and recall, especially when it's the only way that an expert communicates about his or her analyses and conclusions. A written report that gives the judge and jury a document to consult is usually the preferred format for both valuations and rebuttals.

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Written rebuttal reports typically take the form of memos or letters that describe:

- The rebuttal expert's methodology,
- Key errors and discrepancies,
- Authoritative references to textbooks and reputable websites, and
- Exhibits that quantify the effects of the other experts' errors, omissions or discrepancies on their conclusions.

Often alternative amounts are quantified for each error separately, cumulatively and in various combinations to help triers of fact decide cases. A strong, relevant rebuttal goes beyond critiquing another expert's report. Objective rebuttal experts identify areas of agreement as well as *all* errors, omissions and discrepancies — not just those that support their attorneys' theories or their clients' financial interests.

Hard work

Most clients don't realize how much time and effort goes into preparing a rebuttal report. In addition to evaluating the opposing side's conclusions, a strong rebuttal provides enough detail — usually in a formal written format — to help the judge and jurors understand the valuation process. This, in turn, results in more informed decisions about the value of a business interest or an estimate of damages. ■

Tax law update: Hiring an appraiser for your estate

A law extending the Highway Trust Fund requires large estates to report the fair market value of property at the owner's death. As a result, many estates will need to hire outside appraisers to comply with the requirements of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.

Originally, this requirement went into effect immediately for estate tax returns filed after July 31, 2015. The IRS subsequently decided to postpone the due date for filing these returns until February 29, 2016, to give the agency more time to work out the implementation details. Estates shouldn't submit any statements of value until the IRS issues the requisite forms or further guidance.

Who's affected?

Federal tax law requires an estate's executor or administrator to file an estate tax return if the gross value of the estate exceeds the basic exclusion. For estate tax returns filed for 2015 and 2016, the basic exclusion is $5.43 million and $5.45 million, respectively, per individual (excluding any adjustments for unused exclusion amounts from deceased spouses). Now estate tax returns also must include a statement identifying the fair market value of any property held in the estate at the owner's death.

Why does the IRS want estate tax appraisals?

This requirement is designed to provide consistent basis reporting between property values reported for estate tax purposes and the values reported for the same property for future income tax purposes. The goal is to prevent heirs from understating their tax liabilities when they later sell inherited assets.

When must statements be submitted?

Statements of fair market value must be furnished to the IRS by the earlier of 1) 30 days after the date the estate tax return is required to be filed or 2) 30 days after the estate tax return is actually filed. Any understatement of tax liabilities due to the overstatement of basis under this provision would be assessed a 20% accuracy-related penalty.

Additionally, executors or administrators must provide statements of fair market value to each of the estate's beneficiaries. These statements will facilitate federal income tax reporting when the beneficiary subsequently transfers inherited assets.

Even if no estate tax return is required, an estate may obtain an appraisal of certain assets that have appreciated in value. Doing so establishes a "stepped-up" basis in these assets.

Why do estates need appraisers and business valuators?

The fair market value of certain assets, such as cash or marketable securities, is readily available. But valuing other assets, including personal property, real estate or private business interests, is more subjective. Do-it-yourself appraisals are likely to raise a red flag with the IRS. As a result, many large estates are hiring appraisal professionals to help ward off an IRS attack, especially when control and marketability issues are involved. ■