

Viewpoint on Value

M&A risks

A valuator can help evaluate whether a deal makes sense

Truth or fiction?

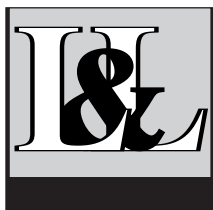
The small stock premium debate

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Noncompetes can create nasty tax surprises



PLUS: Industry consolidation and value



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M&A risks

A valuator can help evaluate whether a deal makes sense

Mergers and acquisitions often make sense on paper. Purchasing a competitor may provide the buyer with an inorganic way to expand into new geographic markets or offer a broader product mix. Beyond increasing market share, the buyer may pursue a transaction to supplant operational weaknesses or to acquire talented workers in a scarce labor market. But many mergers and acquisitions fail to increase shareholder value.

Why buyers may overpay

Regardless of the industry or geographic location, several factors may cause a buyer to overpay and the merger or acquisition to fall short of expectations. For instance, there may be:

Inaccurate assumptions. A purchase price is only as reasonable as its underlying assumptions. In many cases, buyers forecast unrealistic synergies and economies of scale. Moreover, some buyers 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 is more likely to overpay.

Market-driven pricing pressures. 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 merger and acquisition activity, management may feel compelled to pay overly high acquisition premiums to maintain sufficient market share. (See "Industry consolidation and value" on page 7.)

Incomplete valuation analyses. Before making a formal offer to merge with or acquire another business, management should obtain a thorough valuation analysis incorporating *all* three valuation approaches: cost, market and income approaches. Any differences between the outcomes of the three approaches should be reconciled to arrive at a reasonable purchase price.

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 are rarely sufficient as the sole basis for a deal.

Consequences of overpayment

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.

For instance, funeral home giant Loewen Group was unable to meet its debt obligations following an aggressive acquisition campaign in the 1990s. In 1999, when it was evident that its botched roll-up strategy missed the mark, Loewen sought bankruptcy protection.

Fortunately, 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. 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 are usually not reflected on the buyer's balance sheet.

Deteriorated financial ratios. 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.

Lost investment opportunities. Companies have resources to pursue only a limited number of investment opportunities. When they overpay in a merger or an acquisition, they can't afford other essential activities and operations, such as research and development, new product launches, debt service and advertising campaigns.

Lessened stakeholder confidence. News of lackluster postmerger performance can adversely affect the buyer's employees, lenders and investors. Accordingly, productivity may slide, key employees may abandon ship, bankers may call demand notes or investors may file class action lawsuits.

THE IMPORTANCE OF DUE DILIGENCE

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.

Lessons learned

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 makes sense from a financial perspective. ■

Truth or fiction?

The small stock premium debate

Does Wal-Mart face the same risks as a single-store retailer? Many experts consider small companies riskier investments than their larger counterparts. Compared with large public conglomerates, small businesses are more likely to suffer from key person and concentration risks.

Small companies also have less access to bank financing, weaker internal controls, less diversified product lines, and less bargaining clout with suppliers and customers than larger companies. Moreover, smaller businesses have fewer resources to weather temporary economic downturns.

Empirical studies

To accommodate these incremental risks, investors generally demand a higher return for purchasing stock in small businesses. Several empirical studies — most notably those published by Ibbotson Associates and PricewaterhouseCoopers — support this logic.

These studies have found a direct inverse relationship between firm size and return over the long term. For example, in December 2004, Ibbotson reported a 6.34% small stock premium for the smallest stocks traded on the New York Stock Exchange (NYSE).

Specifically, this premium quantifies the historical geometric difference since 1926 between the performance of the Standard & Poor's index of 500 stocks and the performance of small stocks on the NYSE (represented by the 10th capitalization decile — the smallest 10% of stocks on the NYSE).

IRS challenges

Pursuing higher values, the IRS has begun to challenge small stock premiums. The IRS argues that the Ibbotson and PricewaterhouseCoopers studies are flawed, contending that the small stock effect has dissipated in recent years.



WHAT'S THE VALUATION IMPACT?

To capture the incremental risks of investing in small companies, valuers traditionally use the small stock premium as an objective basis for increasing a small company's cost of equity. Cost of equity is a component of a subject company's discount and capitalization rates. In short, the small stock premium increases a subject company's cost of capital, thereby decreasing its value.

To add fuel to the IRS's fire, Brian Becker, PhD, and Ian Gray published a study in a 1999 article in *Business Valuation Review* that contradicts conventional valuation theory regarding small stocks. When they included only returns since 1980, or used geometric (or compound) rates of return (rather than the historic returns), they were able to eliminate the size phenomenon.

Recent case law has also fueled the small stock debate. In the *Estate of Jung*, the Tax Court ruled that size alone does not warrant an increase in the company's discount rate. But, on the other hand, the Tax Court confused matters when it affirmed the validity of the small stock premium in the *Estate of Klaus*.

Clearly, though, valuers shouldn't complacently apply a small stock premium when valuing private businesses. Courts have expressed a preference for experts who evaluate precisely how a company's specific operating characteristics might warrant a higher discount rate.

Small stock premium defense

Valuers almost universally disagree with the IRS's contention that small stocks carry the same risks as large stocks, and competent valuers are prepared to defend their small stock premiums on the stand.

But in light of the recent debate, the small stock premium is not a sure win. A valuation report providing only a tertiary explanation of how the valuator arrived at his or her cost of capital may not be sufficient. Linking the increased discount rate to the company's specific characteristics, rather than to size alone, can help support the value conclusion. ■

Business valuation designations

If you have trouble deciphering the alphabet soup of business valuation designations, you're not alone. This chart will help familiarize you with the most common business designations. It may serve as a starting point for selecting qualified experts as well as for developing deposition and trial questions for the opposing side's expert.

It's important to note that several of the referenced organizations are working together and offer varying levels of reciprocity. Accordingly, completion of all the specific requirements for the designations as outlined above may not be required.

For more information on these business valuation designations, visit the professional organizations' Web sites. ■

| Professional organization | Designation | Required work experience |
|--|---|--|
| American Institute of Certified Public Accountants (AICPA) www.aicpa.org | Accredited in Business Valuation (ABV) | CPA license + completion of 10 valuations |
| American Society of Appraisers (ASA) www.appraisers.org | Accredited Member (AM) | 2 years' BV experience + 2 sample reports |
| | Accredited Senior Appraiser (ASA) | 5 years' BV experience + 2 sample reports |
| Institute of Business Appraisers (IBA) www.go-iba.org | Certified Business Appraiser (CBA) ¹ | 10,000 hours' BV experience <i>or</i> 90 hours of courses + 2 sample reports |
| | Master Certified Business Appraiser (MCBA) | CBA designation + another BV designation + 15 years' BV experience |
| National Association of Certified Valuation Analysts (NACVA) www.nacva.com | Certified Valuation Analyst (CVA) | CPA license |
| | Accredited Valuation Analyst (AVA) ² | 2 years' BV experience <i>or</i> completion of 10 valuations |

¹ IBA also offers a temporary designation called Accredited by IBA (AIBA) for members progressing towards the Certified Business Appraiser (CBA) designation.
² NACVA also offers the AVA certification to government employees under a different set of criteria.

Noncompetes can create nasty tax surprises

Companies routinely require owners to sign employment and noncompete agreements to prevent shareholders or partners from taking clients with them if they leave. These protective agreements are especially popular among professional service companies, such as

advertising agencies and accounting firms, which rely heavily on client- and customer-based intangible assets.

But if these contractual obligations remain in place when a company liquidates or an owner cashes out, it could lead to tax deficiencies for both the company

and the individual owner(s). Fortunately, there are ways to minimize the tax obligations.

Taxpayers debate

When shareholders or partners leave or the business liquidates, it commonly distributes cash and other property to owner(s). These distributions trigger two types of tax obligations.

First, in accordance with Internal Revenue Code Section 336(a), the business must recognize a gain to the extent that the distributed assets' combined fair market value exceeds their adjusted basis. In addition, the owner must pay capital gains tax on the difference between the distributed assets' combined fair market value and his or her equity basis.



The appropriate tax treatment is fairly straightforward for cash, equipment and other tangible assets. But intangible assets represent a gray area — and taxpayers and the IRS vehemently disagree about how to treat them. In particular, a question has arisen regarding who owns client- and customer-based intangibles.

Taxpayers typically believe that intangible assets — such as the company's client base, customer lists, workpapers and goodwill — are a form of professional goodwill and, therefore, belong to the individual owners. Conversely, the IRS claims that the company owns these intangibles and aggressively issues deficiency notices to taxpayers who disagree.

Recent cases provide guidance

The IRS wins nearly 75% of all Tax Court cases. Despite its strong track record, the IRS was unsuccessful in collecting additional taxes on client- and customer-based intangibles distributed in two recent liquidation cases.

In *Norwalk*, two CPAs traded their firm's assets for partnership interests in a larger regional accounting firm. The IRS argued that the firm and its partners should have realized gains on the liquidation of the firm's goodwill. Although the partners had signed employment and noncompete agreements, the contracts had expired before the firm's liquidation.

In the absence of effective contractual agreements, the Tax Court ruled that client- and customer-based intangible assets have no "meaningful value," and the partners' "personal goodwill did not attach to the corporation."

The Tax Court reached a similar conclusion in *Martin Ice Cream*. Because Martin Ice Cream, an ice cream distributor, did not require its owner, Arnold Strassberg, to sign noncompete or employment contracts, the Tax Court ruled that his relationships with supermarket chains and Häagen-Dazs were not corporate assets. Instead, these customer-based intangibles and personal goodwill belonged to Strassberg, rather than Martin Ice Cream. This case is important because it demonstrates that the court draws no distinction between professional service firms and manufacturing or retail operations.

Liquidation plan helps

Based on these cases, it appears that the Tax Court has provided a safe harbor against tax liabilities associated with liquidated client- and customer-based intangibles if a company terminates its noncompete and employment agreements before liquidation. To avoid IRS challenges of terminated contracts, however, a legitimate business purpose for terminating their noncompete and employment agreements should be documented.

For instance, the company's written liquidation plan might state that the agreements were rescinded as part of an employee's termination agreement and intended to absolve the company from any future lawsuits related to the restrictive agreements. The liquidation plan should also spell out that, when the company

terminates the contracts, it officially forfeits its rights to client- and customer-based intangibles, giving them up to its shareholders or partners. Of course, legal consultation is suggested in such matters.

Divide and conquer

A valuation professional can help support a liquidation plan and accompanying tax returns. When a company liquidates, its tax consequences are based on the fair market values of its distributed assets. Intangible assets complicate valuation matters and often require creative solutions.

In addition to estimating the company's entire fair market value, liquidation may require a valuator to split fair market value into its tangible and intangible components. From there, the valuator might need to divide intangible value into two pieces: the company-owned intangibles (such as patents and brand names) and shareholder-owned intangibles (such as the company's client base, customer lists and goodwill).

An experienced valuator familiar with the nuances of appraising intangible assets can be key in ensuring that a liquidation plan achieves the best results. ■

INDUSTRY CONSOLIDATION AND VALUE

Over the past decade, countless industries have consolidated, including accounting firms, auto dealerships, banks, funeral homes, printers and wholesale distributors. Consolidation offers participants in mature industries a way to improve waning profits and manage mounting competitive pressures.

What's the impact?

Valuators keep a close eye on industry consolidation, because merger and acquisition activity can have serious valuation consequences. For instance, consolidation may result in:

Enhanced liquidity. When an industry is in acquisition mode, its participants may find it easier to sell the business. In some cases, enhanced liquidity translates into lower marketability (or illiquidity) discounts, especially for controlling interests.

Greater uncertainty. Industry consolidation can increase market volatility. In some cases, this uncertainty increases a company's cost of capital. In others, projected financial performance may become less stable. Accordingly, valuers may opt to use discounted cash flow techniques rather than simpler income capitalization methods.

Ample transaction data. Judges and arbitrators customarily prefer the market approach for its perceived simplicity and objectivity. Consolidation provides a wealth of transaction data, which valuers can use to derive the value of industry participants. And when a company's industry faces consolidation, it may entertain various purchase offers, which can provide another objective benchmark for its value.

Inflated pricing multiples. It's simple economics: Consolidation increases the demand for a limited number of acquisition targets. Together, the limited supply of industry participants and the excitement of "acquisition frenzy" often boost average industry pricing multiples to record highs. These inflated prices are usually temporary, which underscores the importance of considering the valuation's "as of" date.

What's the bottom line?

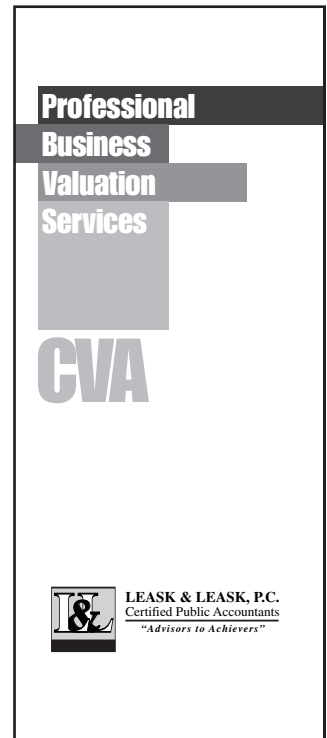
Consolidation affects each valuation assignment differently. The extent to which current (or prospective) consolidation may affect a company's value depends on its attractiveness as an acquisition target — or the viability of its acquisition strategy. In their reports, valuers reconcile industry consolidation trends with the company's specific characteristics.

John M. Leask, II (Mac) values between 20 and 50 businesses annually for a variety of reasons. **He has done valuations to support estate and gift tax returns and has testified as an expert witness in divorce cases and shareholder disputes. Most often, Mac's valuations are done in conjunction with the purchase or sale of a business** — to assist shareholders or to set values when shareholders purchase the interest of a retiring shareholder. Recent examples of valuation engagements include a valuation done to support a pre-nuptial agreement and a valuation of a franchise business prior to purchase. Here are some more specifics about the types of engagements Mac performs:

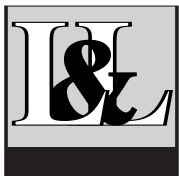
- **Due Diligence & Assisting in the Purchase of a Business:** Mac has assisted the purchasers of businesses by determining or reviewing the offer. He is often called upon to help negotiate the purchase price and perform due diligence. These services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to the future success of the businesses.
- **Family Limited Liability Partnerships/Companies & Closely Held Businesses:** Mac is regularly called upon to value various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuers.
- **Expert Witness in Divorce & Shareholder Disputes**

More information about Leask & Leask's valuation services (including case studies) may be found at our firm's web site (www.leask.com).

Contact Mac for a copy of our business valuation brochure, to schedule an individual consultation, or to discuss any other points of interest. He may be reached by phone at (203) 384-1237, Ext. 223, toll free at 1-888-LEASKPC (532-7572), by fax (203) 384-9157, or by e-mail: mac@leask.com. Be sure to visit our web site at www.leask.com.



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