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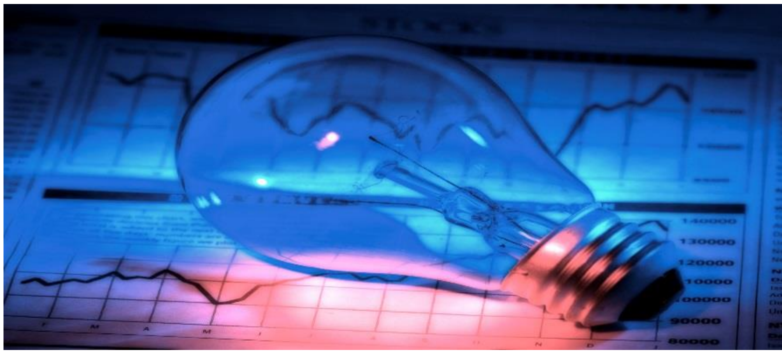

When Value Counts…

2nd Quarter 2016

We hope that you are enjoying the spring season. In the 2nd Quarter 2016 newsletter, you will find the following short articles:

- Pepperdine Reports Strong Valuations in Main Street and LMM Firms
- Judge Laro Toplines Panel on Hot Issues in Tax Valuation
- Discounts for Lack of Marketability (DLOM) Ruling Promises End to 'Most Difficult Case'
- How to Avoid Tripping Up Over Subsequent Events
- Economic Update at a Glance

We hope that you enjoy the articles. Please feel free to call us if you need any assistance with valuation matters. Thank you, and we look forward to working with you.

Pepperdine Reports Strong Valuations in Main Street and LMM Firms

The Pepperdine Capital Markets project conducts ongoing research concerning the cost of private capital across market types and the investment expectations of privately held business owners. The International Business Brokers Association (IBBA) and M&A Source Market Pulse Quarterly Survey Report for the third quarter of 2015 (3Q15) examines the market conditions for businesses being sold in Main Street (values $0 to $2 million) and the Lower Middle Market (values $2 million to $50 million) sectors.

Pendulum shift: "The market is moving to a seller's market in each sector, especially as deals get larger," says Cress V. Diglio, Transworld Business Advisors and IBBA chair. "Business owners who are selling now are 'ahead of the curve' and are getting rewarded with very strong valuations. Eventually, as more and more baby boomers seek to retire and put their businesses on the market, there will be an oversupply of sellers and the market will most likely swing back to a 'buyer's market.'"

Looking at the data the last five quarters, valuations are similar for all sectors. The report found "a slight decrease" in the $1 million to $2 million valuation range. The median multiple paid (SDE) was 2.8 for 3Q15 (down from 3.3 in 3Q14) and the median multiple paid (EBITDA) was 3.5 for 3Q15 (down from 3.8 in 3Q14). "This tends to be the price range at which individual buyers are priced out and existing businesses owners are inclined to buy, but only when it can add to their current operations," says the report.

The survey for 3Q15 was completed by 192 respondents, representing 20 regional and international M&A and business broker associations.

Judge Laro Toplines Panel on Hot Issues in Tax Valuation

A panel session by several of the leading minds on taxation to discuss hot topics in valuation was a highlight of the 2015 AICPA FVS conference in Las Vegas. David Laro, a senior judge of the U.S. Tax Court, was there with Judge Kathleen M. Kerrigan. Also on hand was Michael R. Devitt (professor of law, University of San Diego School of Law) and attorney Lawrence A. Sannicandro (Agostino &

Associates PC). The moderator was John I. Forry (University of San Diego School of Law).

Audit risk. Because valuation is involved in so many different situations, there's an overall 50% chance that the IRS will question a valuation, noted Sannicandro. However, this takes into account all valuations, including those for charitable contributions. In many of those cases, the required qualified appraisal is omitted from the return.

He presented some interesting statistics on the prevalence of valuation in Tax Court cases. In 2014, the Tax Court published 422 opinions, of which 148 involved taxpayers represented by counsel (the others appeared pro se). Questions of valuation were resolved, in one form or another, in roughly 52 of those 148 cases, which means that valuation was at issue in about 35% of represented taxpayer cases in 2014. This is up from 20% in 2013.

Smart court. None of the judges on the U.S. Tax Court are specialists, Judge Kerrigan explained. "We all have different backgrounds," she said. Judge Laro mentioned that today's Tax Court judges are "very smart and sophisticated" when it comes to business valuation and they do their own analysis.

Judge Kerrigan gave a brief review of the different types of opinions the Tax Court issues and the weight they carry:

- Summary opinion: This type of opinion is used in small cases ("S cases," no more than $50,000), and there is no right of appeal.
- Bench opinion: This is an oral opinion the judge may issue from the bench during trial. It cannot be relied on as precedent.
- TC memo opinion: This opinion generally is issued in a regular case that does not present a novel legal issue. It addresses situations in which the law is settled or fact driven. It may be cited as legal authority and may be appealed, but it is not binding precedent.
- TC opinion: This type of opinion carries the most weight. It is issued in regular cases that present an important legal issue or principle. It is appealable and may be cited as legal authority.

Judge Kerrigan cautioned the audience that the applicable standard of value in federal tax cases is the fair market value. Be careful not to use the market value (e.g., an actual sale or transfer) because using the wrong standard of value invalidates your analysis.

Judge Laro gave a rundown on key valuation issues, noting that he was speaking for himself, not the Tax Court. After serving 20 years on the court and immersing himself in valuation issues, he has become an authority on valuation.

Tax affecting. Practitioners should check out the IRS's Job Aid that explains the agency's thinking on valuing S corporations, Judge Laro advises. The IRS's position of no tax affecting leans on Gross v. Commissioner and progeny (there are at least five such cases), but it contradicts sound valuation practices, he says. All of the cases were Tax Court memos, so he says to keep in mind that these opinions are not binding on other judges. Therefore, "the final chapter on tax affecting has not yet been written."

Discount for lack of marketability (DLOM). Simply pulling the discount for marketability rate from restricted stock and pre-IPO studies spells trouble, the judge cautions. "I'm bothered by those studies," he says. "Look how old they are. Be careful when you offer them as part of your technique." Today's Tax Court judges know valuation in a way the prior generation did not. And they expect experts to tailor their DLOM to the facts of a particular case. Judge Laro recommends using his Mandelbaum decision (in which he sets forth a multifactor analysis) as guidance for your DLOM determination. (A digest of Mandelbaum v. Commissioner, T.C. Memo 1995-255, along with Judge Laro's opinion, is available at BVLaw).

USPAP. Mere compliance with the profession's standards does not make you a reliable expert for Tax Court purposes, Judge Laro says. Conversely, failure to comply with the standards does not exclude your testimony from consideration.

A key step to ensuring the testimony is admissible is using the correct standard of value, Judge Laro cautions. Like Judge Kerrigan, he warned experts to use fair market value, not market value. While the Tax Code does not provide a definition of fair market value, estate tax regulation §20.2031-1 does. It describes FMV as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." In other words, the focus is on a hypothetical willing buyer and seller that engage in an arm's-length transaction, not on actual sales data. Apply the wrong standard of value and the Tax Court will disregard your valuation opinion.

Attorney involvement. Protect your independence, Judge Laro warns. Most experts have dealt with retaining attorneys who want to steer the valuation by reviewing draft opinions and suggesting (or even ordering) recalculations that favor their side. Know the discovery rules; much of the communication between attorney and expert may be discoverable. If the attorney's involvement crosses the line, the valuation evidence may be spoiled.

Judge Laro mentioned a recent billion-dollar case in which a major law firm told the valuator in writing what number it wanted the expert to reach. The communication was discoverable and ended up in court. "Think of what that does to the valuator's credibility in court," the judge says.

Professor Devitt also cautioned appraisers about their dealings with the attorneys. "Don't let overzealous lawyers push you into untenable positions," he warns. He advised experts to know the Daubert case and the factors it sets forth inside and out because it is almost certain that the other side will file a Daubert challenge. "Sort of" knowing the case is no longer enough to overcome the hurdle Daubert has become.

Discounts for Lack of Marketability (DLOM) Ruling Promises End to 'Most Difficult Case'

Wisniewski v. Walsh, 2015 N.J. Super. Unpub. LEXIS 3001 (Dec. 24, 2015) (Wisniewski II)

Third time's a charm? A nasty shareholder dispute that has lasted for two decades and featured rock-star valuators recently prompted a third appeals court ruling related to the marketability discount.

Case for DLOM: A sister and two brothers owned equal shares in a family trucking business. In 1996, one brother filed an oppressed shareholder action claiming his siblings tried to oust him from the company. The trial court found that the plaintiff brother in fact was the oppressing shareholder and ordered him to sell his interest either to the company or to the two siblings at fair value.

Both parties retained well-known appraisers. When the first trial court set a value without conducting an evidentiary hearing, the parties appealed. On remand, a different trial court heard valuation testimony and largely adopted the calculation the plaintiff's expert proposed. It was based on a discounted cash flow (DCF) analysis. A second appeal followed. The appeals court affirmed nearly all aspects of the trial court's value findings but said the valuation should have included a marketability discount.

Although a marketability discount was only applicable under "extraordinary circumstances" in a forced buyout situation, it was justifiable here because the plaintiff-seller had engaged in conduct that harmed the two other shareholders (defendants) and necessitated the forced buyout. Accordingly, the appeals court remanded again, ordering the trial court to determine whether the prevailing DCF analysis embedded a DLOM and set the applicable DLOM rate.

On the low end of spectrum: A third trial judge (two trial court judges had retired during the litigation) first found that, when the prevailing expert built up his discount rate for the DCF analysis, he did not specifically account for illiquidity. In the valuation trial, he had insisted a marketability discount was inappropriate because the company was successful and would likely take no longer to sell than other closely held companies of similar size and nature with assistance from "the right business intermediary." He also believed the other shareholders would not lose liquidity during the marketing period.

As for the appropriate discount rate, the new trial judge noted that the buyers' expert had valued the company under a market approach and had considered risk factors specific to liquidity-which were pretty much the same factors the opposing expert considered for his discount rate-to arrive at a 35% DLOM. A rate that high would unduly punish the seller and give a significant windfall to the buying shareholders, the trial court said. Case law and studies suggested a broader range, starting as low as 20%, depending on the equities in a given case. Here, a 25% DLOM was appropriate.

The parties appealed anew, but the reviewing court affirmed. It said that neither side had made a convincing argument for second-guessing the trial court's "thoughtful and well-reasoned determination in this most difficult case."

Takeaway: In building up the discount rate underlying his DCF analysis, the prevailing expert did not specifically adjust for lack of marketability (illiquidity). Therefore, an independent 25% DLOM was applicable to the valuation.

How to Avoid Tripping Up Over Subsequent Events

If you're not considering events that happen after a valuation date, you may be compromising your valuation report. Worse, if you're in court, your report could be tossed out. "Hold on," you might be saying. "Events subsequent to the valuation date should be excluded from a valuation analysis." Yes, that's generally true, but there are exceptions. The trick is knowing when you should-and should not-take this information into account.

At the recent AICPA FVS conference in Las Vegas, David Laro, a senior judge of the U.S. Tax Court made it a point to say that some courts have examined subsequent events that are relevant to the taxpayer's perceptions at that time. In some cases, subsequent events were reasonably foreseeable as of the valuation date, so they are relevant to the valuation.

Two categories. There are two categories of subsequent events or information: (1) those that affect value; and (2) those that do not affect value but that do give evidence of value that existed at the valuation date. In general, those that affect value should not be considered-unless they are foreseeable. On the other hand, those events that give evidence of value that existed as of the valuation date may indeed be considered.

This concept is explained very well in several key court cases:

A distinction may be usefully drawn between later-occurring events which affect fair market value as of the valuation date, and later-occurring events which may be taken into account as evidence of fair market value as of the valuation date. When viewed in this light-as evidence of value rather than as something that affects value-later-occurring events are no more to be ignored than earlier-occurring events (Estate of Jung v. Commissioner, 101 T.C. 412, 101 T.C. No. 28 (U.S. Tax Ct., Nov. 10, 1993)).

Subsequent events or conditions which affect the value of the property can be taken into account only if they are reasonably foreseeable on the valuation date. Conversely, subsequent events which merely provide evidence of the value of the property on the valuation date can be taken into account regardless whether they are foreseeable on the valuation date (Morton v. Commissioner, T.C. Memo 1997-166, 73 T.C.M. (CCH) 2520 (U.S. Tax Ct., April 1, 1997)).

In practice. You will typically come up against three broad scenarios during an engagement: (1) the subject company follows its historical path, which can be either normal growth or decline; (2) foreseen or predictable changes or events affect the company; and (3) the company is hit with changes or events that are unforeseen or unpredictable.

When the company is sailing along as historically expected, it is certainly appropriate to use the company's financial information for the year following the valuation date. This is especially true when financial information preceding the valuation date is missing or not available. It is also appropriate to use the company's financial information for the year following the valuation date if it reflects changes caused by foreseen or predictable events. For example, the company may have launched a great new product, landed a big new client, or is modernizing its plant to increase efficiency.

However, it is not appropriate to use the company's financial information for the year following the valuation date if it reflects changes caused by unforeseen or unpredictable events. For example, the surprise loss of a key customer or supplier, an act of Mother Nature that significantly interrupts operations, or an unforeseen change in government regulations that affect the business.

'Knowable' interpretation. Every valuation expert knows that for information to be taken into account it must be "known or knowable." This is sometimes interpreted to mean that financial results through the valuation date that haven't yet been published as of the valuation date are not usable. But a reasonable interpretation is that this unpublished information-although it's not officially compiled-meets the criterion of "knowable." In reality, most CEOs and CFOs have a pretty good idea of what their results were, even though they have not been formally compiled or published.

This same interpretation can also hold true for guideline public company data. For example, if the valuation date is a calendar year, some appraisers would only use data through September 30 for the guideline companies because year-end results would not have been released. However, it would be reasonable to use actual year-end results for the guideline companies. Reasons: The information coincides with the company's year-end, and analysts' predictions of year-end results are available.

What to do. Use professional judgment to determine when it is appropriate to use subsequent events or information as part of the valuation process. If a subsequent event is significant, consider disclosing it in your valuation report, but make it clear that the information was not used to determine value as of the valuation date. If you're involved in a court case, consult the attorney to see whether the particular jurisdiction allows the consideration of subsequent events.

Economic Update at a Glance

The economy slowed for the second consecutive quarter in 4Q 2015, where GDP only expanded 0.7%. Slowed consumer spending, a deterioration in the nation's trade balance, a sharp drop in private investment, and a smaller buildup in business inventories were largely the cause of the fourth-quarter slowdown. Business spending on structures experienced its greatest drop since 3Q 2012, while spending on equipment fell for the third time in the past four quarters. For 2015 as a whole, GDP rose 2.4%, matching the prior year's growth. Economic growth has not topped 3.0% since 2005.

Though consumer spending lost ground in the fourth quarter, positive assessments of the job market drove up consumer confidence at the end of the year and for good reason: Job growth in the fourth quarter was the strongest of the year. Further, 2015 capped off the best two-year period of hiring since the period ending in 1999. Over the past 12 months, the unemployment rate and the number of unemployed persons were down by 0.6 percentage point and 800,000, respectively. Moreover, wages for private employees rose faster in 2015 than at any time since the recovery began.

The positive labor market conditions, coupled with inflation expectations, contributed to the Federal Reserve's December decision to raise its target for the federal funds rate for the first time since 2006. The increase came after seven years of the most accommodative monetary policy in U.S. history.

The manufacturing sector continued to be rocky in the fourth quarter. The Institute for Supply Management's manufacturing index showed that the manufacturing sector contracted in both November and December, falling to its lowest level since June 2009. The new orders component dropped to its lowest level in over three years, as did the component measuring production. Further, industrial production fell at an annual rate of 3.4% and remained nearly 2.0% below its rate from a year ago. Though warmer-than-usual temperatures reduced demand for heating, which caused the utilities industry group to decline, the mining group fell for four consecutive months while manufacturing dropped in both November and December.

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