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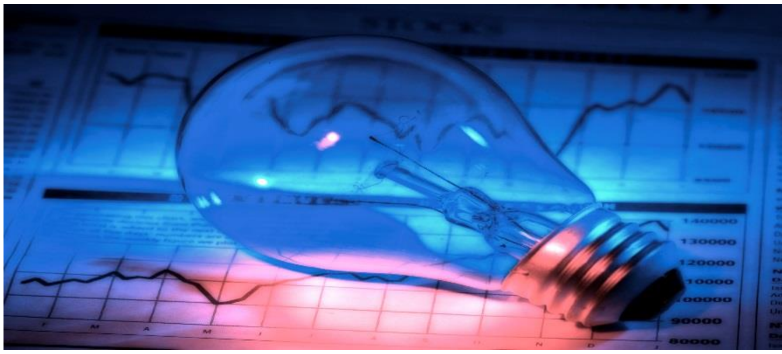

When Value Counts…

3rd Quarter 2016

We hope that you are enjoying the summer. In the 3rd Quarter 2016 newsletter, you will find the following short articles:

- Prince's Death Spotlights Value of Right of Publicity
- Valuing a Franchise? Consider These Seven Specific Characteristics
- ESOP Valuations in the Wake of 'Final' DOL Rule
- FASB Issues New Lease Standard; Veers from IASB
- 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.

Prince's Death Spotlights Value of Right of Publicity

The recent death of Prince points up an intriguing valuation issue known as the "right of publicity." This is a form of intellectual property that covers an individual's likeness, including his or her name, image, signature, voice, and so on. Of course, there could be a great deal of value when it comes to a celebrity.

Vexing problem: An article in Trusts & Estates on the Prince situation says that there is a lack of guidance and precedence for estate taxation of a posthumous right of publicity. Also, determining a date-of-death fair market value can be complex, so there can be wide discrepancies. For example, Michael Jackson's estate valued his name and likeness at $2,105, but the IRS says the value is $434 million! The IRS and the Jackson estate are scheduled to appear before a Los Angeles Tax Tribunal in 2017 to settle their dispute, says the article.

The first case that allowed for individuals to maintain their right of publicity seems to be the Zacchini case that went to the U.S. Supreme Court (Zacchini v. Scripps-Howard Broadcasting Co., 433 U.S. 562 (1977)). That case involved newsreel coverage of a performer who shot himself out of a cannon. He claimed that the news exposure diminished his ability to capitalize on his skills. But a person doesn't have to be a celebrity or of the same caliber as a human cannonball to get caught up in this issue. A kindergarten teacher sued Nestle over the unauthorized use of his image on labels of Taster's Choice coffee. A jury awarded him $15.6 million, which represented 5% of the profits on the coffee plus lost licensing fees (the decision was reversed and the parties later settled).

What to do: Of course, the valuation of the right of publicity involves techniques and methods common to the valuation of other IP assets, such as determining royalty rates, examining cash forecasts, choosing a discount rate, and so on. But those who may be experts in other areas of IP valuation may want to consider consulting with someone who works with the right of publicity regularly to help ensure that the valuation is defensible.

Valuing a Franchise? Consider These Seven Specific Characteristics

A recent court case (La Verghetta v. Lawlor, Index No. 5934/2014, N.Y. Sup. Ct. [County of Westchester] (March 9, 2016) involving the valuation of a chain of Planet Fitness operations underscores the challenge of valuing a franchise. True, many of the factors you consider will not be very different than those for any other type of company. But there are franchise-specific characteristics that can trigger a much greater degree of risk than an independent business.

First thing to do. Examine the franchise offering documents and the franchise license agreement (and any amendments). These documents control the investment and working relationship with the franchisor. There is a wide disparity of relationships between franchisees and franchisors that can drive the risk and the value of the business, so you need to thoroughly understand the provisions. Many of the following franchise-specific elements reflect what is contained in the franchise documents and the underlying nature of the relationship with the franchisor.

1. Outside control. The franchisor exercises significant control over the franchisee's operations. This control can extend to many details of the operation, including location, suppliers, hours of operation, signage, and so on. The franchisee must also make required payments during the year. There also may be a restricted ability to make business decisions, such as limits on expansion, product offerings, marketing costs, and many other aspects—all buried in the franchise agreement.

You can think of the franchisor's influences over growth or direction of the business as akin to key-customer risk. That is, someone can take actions outside of the control of the business that could affect brand value. What is the franchisor's plan to build up the brand? What about expansion plans? Of course, these plans can go awry, such as the overexpansion of Krispy Kreme. That franchise has rebounded, but there's a long list of defunct franchise brands. Has anybody eaten a hamburger lately at a Burger Chef?

2. Local market. In certain market areas, there are well-established franchises and franchisees who already have several locations, so there's a built-in ready market for a seller. For less-established franchises, it will be tougher to sell, so marketability will be an issue. Also, because franchisors typically have the right of first refusal on the sale of any business, they are a potential bidder. The franchisor will always know more about the available franchises than any other potential bidder, so an outside bidder has to spend more money and effort to even approach the franchisor's knowledge of the available franchise.

3. Required improvements. One element that often pops up is in the area of improvements or maintenance of the location. The timing of this issue may not always be a good thing. For example, a franchise restaurant could make significant improvements to its dining area—and then the franchisor mandates a makeover of the restaurant design and layout. The franchisee will likely be required to make those changes despite the fact that it has just sunk a significant capital expenditure into the business. Therefore, ask the franchisee whether it is aware of any plan changes. If the franchisor has a tendency to make changes fairly often, or if it has not done so for a while, a change may be due.

4. Franchise disputes. Another significant risk in franchise businesses is franchise dispute risk. The potential outcome here is the loss of the ability to continue doing business. A good example of this is Quiznos, where franchisees filed lawsuits over disputes about food costs, marketing, royalties, and other matters. This went on for years, and, after a settlement was reached, Quiznos filed for bankruptcy. While the chain has rebounded, more than 2,000 locations were closed.

5. Threats by franchisors. Franchisors keep their franchisees in line with the threat of nonrenewal. But you should be able to see warning signs, such as below-average sales, skipped payments, lots of opting out of marketing campaigns, too many customer complaints, or legal troubles.

6. Image problems. While franchise owners enjoy whatever positive image there may be in the brand name, they also run the risk of negative effects, such as what happened with Subway or Chipotle. When bad news hits the media, sales for all locations can plummet. Sometimes, the franchisees have no recourse because they often waive their rights to sue the franchisor for any such incident in their franchise agreement.

7. Escape hatch. If a nonfranchised business opens and the owner sees that it's just not going to work out, he or she can simply get out. But it can be a lot tougher to get out of the business in a franchise because the owner may not have that option.

Once you consider these franchise-specific elements, how do you deal with their impact? You can adjust the discount rate or the cap rate to take into account the extra risks, or you could adjust the cash flows. For example, assume there's a serious dispute and you estimate that there is a 50% chance that the business will lose 50% of revenue this year, a 25% chance of growth, and a 25% chance of staying even. A probability-weighted cash flow that incorporates this risk can be developed.

ESOP Valuations in the Wake of 'Final' DOL Rule

The valuation community breathed a sigh of relief when the Department of Labor removed appraisals entirely—not just ESOP appraisals—from fiduciary treatment in its final rules designed to strengthen retirement security (www.dol.gov/ebsa/regs/conflictsofinterest.html). But the appraiser-as-fiduciary issue is not completely put to rest.

Strong signal. In the final rules, the DOL makes it a point to say that it is very concerned about this matter and will take it up again in separate rulemaking. "I think the DOL is sending a signal … actually a fairly strong one," says attorney Bruce Ashton (Drinker Biddle Reath LLP). Ashton's firm was involved in drafting the DOL/GreatBanc Fiduciary Process Agreement, an important settlement agreement that covers ESOP transactions and valuation issues.

"The good news for appraisers and valuation professionals, of course, is that they were dropped from the final rule," says Ashton. "The bad news is that the DOL goes out of its way to say—a number of times in one page—that this is an area that it is concerned about—especially in the ESOP context—and strongly suggests that it will take up this issue later on in a 'separate project.' So the issue is not dead, just on hold—though perhaps an extended hold."

He points out that this extended hold also represents good news and bad news. "On the good news side, the 'separate project' is unlikely to happen during the remainder of the Obama Administration, and whether it comes to pass under a future administration is anyone's guess," he says. "I suspect that if a Republican is in the White House, it will not, but—and here is the bad news part—if the next president is a Democrat, there is a fair chance that it will. Probably not right away, because they will have their hands full dealing with issues related to the just-released regulation. But I don't think the appraisal issue will go away."

Good outcome—so far. Valuation experts have reason to be happy with the outcome so far. "Stern Brothers Valuation Advisors is pleased to see that ESOP valuation experts are exempted from being named as a fiduciary to the ESOP," says Steven York, the firm's senior vice president. BVU attended a session on ESOPs York presented at the AICPA Forensic and Valuation Services Conference 2015 in Las Vegas. "The concerns expressed by various practitioners in the valuation industry about the increased costs of liability insurance, increased time to prepare the annual valuation reports and related burdens were all addressed appropriately by the valuation industry," he says.

But York notes that it would have been helpful if the DOL had given more guidance since the appraiser-as-fiduciary issue is still open. "What was not discussed was the issue that if the valuation expert were to be the fiduciary for valuation issues for the ESOP trust, what role does the trustee play?" He also hopes that the DOL would issue a regulation defining the "adequate consideration" regulation that limits the value at which an ESOP can conduct a transaction. "Since a proposed definition of adequate consideration was published in May of 1988 no regulations have been published or proposed by the DOL," he says.

Different animal. York explains that the valuation of an ESOP is very different from other valuation engagements. "The conclusion of value for ESOP purposes can cause a run of employee terminations if the value is set too high," he says "It can cause the ESOP participants to call for DOL review if the value is set too low, and it can facilitate an unfair transaction."

York feels that the best training for ESOP valuation work is to value the same interests in an ESOP trust for a 25-to-30-year period. "Only then can valuation experts understand their role with ESOP transactions, ESOP benefit payments to participants, the effect of debt structures used in stock purchases and the impact of the repurchase obligation on the future cash flows of the sponsoring company," he says. "In addition, if a valuation expert is to prepare any conclusion of value for ESOP purposes, they must read and understand the ESOP Trust and Plan documents, any Stock Purchase agreement, any Debt agreement, the benefit payment policy of the sponsoring company and all the related documents that support the ESOP documents."

Crackdown continues. The DOL continues to take action against valuations it perceives as faulty. "I've seen it in lots of DOL investigations of ESOPs where they frequently question the valuations used," says Ashton. For example, the agency recently obtained a judgment against fiduciaries of a California ESOP in a lawsuit alleging the fiduciaries paid inflated prices for company stock. Also, the DOL recently filed a complaint against owners of a Florida company for selling their stock to their ESOP for almost double the alleged fair market value. “I think it is an ongoing issue that probably is going to continue regardless of whether the DOL takes regulatory action,” he says.

Ashton advises that practitioners should proactively think about how to strengthen ESOP valuation practices and procedures in the future. “Put effort into thinking about a worst-case scenario in terms of a DOL regulatory regime. That’s not an over-the-top suggestion because something’s going to happen.” He also suggests that a self-regulation approach—a renewed effort on the setting of standards and practices—may make some sense for the valuation profession.

What to do. Use the recommendations contained in the GreatBanc settlement agreement when doing an ESOP valuation. The agreement includes a set of policies and procedures that GreatBanc must follow in the future when it is engaged to purchase or sell employer securities that are not publicly traded. The DOL has made past remarks that everyone will "do well to take notice of" the agreement, even though it formally applies only to GreatBanc. For example, it contains rules on independence and stresses the importance of documenting the reasonableness of management projections. A few of the other guidelines it recommends are:

- The trustee is required to request five years of audited, unqualified financial statements. If the trustee relies on a lower level of financial statements (i.e., qualified or unaudited financial statements), the trustee must document the reason that it is prudent to rely on such financial statements in order to proceed with the transaction.
- A "Trustee Report" that constitutes an analysis of the valuation report must be created. According to the settlement, 16 specific items (which relate to methodologies, accepted practices, documentation, and analytical measures) must be documented.
- Documentation of the trustee's evaluation of the valuation report must include disclosure of material points on which personnel disagreed.

After the GreatBanc agreement was issued, valuation analysts began to incorporate relevant parts of it into their reports, such as additional boilerplate language and more explanation and documentation.

“Stern Brothers Valuation Advisors treats the settlement agreement as guidelines for a good ESOP valuation,” says York. “The rules on independence we follow, but we always have for more than 30 years. The other topics in the settlement agreement are being reviewed for all DOL valuation ‘enforcement actions’ as the DOL calls them now, so we include a statement that we have prepared the report in compliance with the guidelines from the settlement report. Then we back up that compliance in the text of the report by addressing all the items in the settlement agreement, to the extent they are applicable in each report.”

You can get a copy of the actual GreatBanc agreement from the DOL’s website (www.dol.gov/ebsa/pdf/esopagreement.pdf) or you can purchase a version with excellent commentary from the attorneys who negotiated the agreement. That version is The DOL Fiduciary Process Agreement for ESOP Transactions, and it’s available from the National Center for Employee Ownership (www.nceo.org).

FASB Issues New Lease Standard; Veers From IASB

U.S. companies will be required to add leases to their balance sheets under an overhaul of the lease accounting rules by the FASB. Accounting Standards Update (ASU) No. 2016-02, Leases, will apply to both capital (aka finance) and operating leases. Up to now, GAAP has required only capital leases to be recognized on lessee balance sheets.

Key impact: Lessees will be required to recognize the value of assets and liabilities on the balance sheet for the rights and obligations created by all leases with terms of more than 12 months. While a company’s book value isn’t likely to change significantly under the new rule, some financial ratios (e.g., return on assets) could be affected because companies will appear more leveraged.

As under current GAAP, the accounting for a lease primarily will depend on its classification as a capital or operating lease: For capital leases, lessees will recognize amortization of the right-of-use asset separately from interest on the lease liability. For operating leases, lessees will recognize a single total lease expense.

Out of synch: The International Accounting Standards Board (IASB) also recently issued a final lease standard (IFRS 16, Leases) that will require companies to bring leases onto the balance sheet. The January 27 issue of BVWire reported that it would not be fully converged with the FASB standard, which is how it panned out. The IASB and FASB agree on many points, including the requirement that all leases of more than 12 months be recognized on lessee balance sheets. But they diverge in some respects, including lease classification. The FASB standard uses a dual-reporting model for lessees, while the IASB standard uses a single-classification model that requires lessees to account for all leases as capital (finance) leases.

The FASB standard will take effect for public companies for fiscal years, and interim periods within those fiscal years, beginning after Dec. 15, 2018. For all other organizations, the ASU on leases will take effect for fiscal years beginning after Dec. 15, 2019, and for interim periods within fiscal years beginning after Dec. 15, 2020. Early application will be permitted for all organizations.

Economic Update at a Glance

The U.S. economy—as indicated by GDP—grew at an annual rate of 0.5% in the first quarter of 2016. This was the third consecutive quarter of slowed growth, as well as the slowest pace in two years. Consumer spending continued to slow as Americans spent less on durable goods, most notably motor vehicles and parts. Government spending rose this quarter, with increased expenditures at the state and local government level offsetting declines in federal government spending. Business investment fell sharply in the first quarter, dragged down by a large decline in spending on equipment and structures. An increase in imports also weighed on GDP, as did large decreases in private inventory investment and in exports.

The Federal Open Market Committee made the decision to maintain the target range for the federal funds rate at 0.25% to 0.5%. In making its decision to leave the target for the federal funds rate unchanged, the FOMC stated that global economic and financial developments continue to pose risks and that inflation is currently running below the target of 2.0%, in part because of earlier declines in energy prices.

The pace of new job creation remained robust in March, rising 215,000 after a revised increase of 245,000 in February. The employment report also highlighted that the average hourly earnings increased 0.3% from a month earlier, while the jobless rate crept up to 5.0% as more workers entered the labor force. Construction payroll growth accelerated in March, while manufacturing employment slumped by the most since December 2009.

The manufacturing sector, as measured by the Institute for Supply Management’s manufacturing index, improved slightly in March. The index showed that the manufacturing sector expanded in March, following five months of contraction. Industrial production, on the other hand, fell in March and has now only risen in one of the past seven months. The industrial production report also showed the capacity utilization retreated for the second month in a row.

The services sector continued to expand in March, as measured by the Supply Management’s services index, but the pace quickened for the first time in the past five months. The majority of respondents’ comments indicated that business conditions were mostly positive. Further, respondents believe that the economy is stable and will continue on a course of slow, but steady, growth.

The stock market surged in March and moved most of the major indexes into positive territory for the year. T. Rowe Price observed that the gains appeared driven in part by a rebound in the price of oil and other commodities, and the energy and materials sectors were among the best performers in the Standard & Poor’s 500 Index. Market volatility was mild in March.

Intermediate- and long-term U.S. Treasury yields fell sharply in the first quarter, as investors’ risk aversion at the beginning of the year benefited safe-haven securities. Long-term Treasuries finished the first quarter with quarter-end yields that were their lowest since the first quarter of 2012.

Building permits and housing starts fell in March, though both remained above their year-ago levels. After a slump in February, existing-home sales bounced back in March, bolstered by big gains in the Northeast and Midwest. The national median existing-home price for all housing types continued to climb, marking the 49th consecutive month of year-over-year price gains. The National Association of Realtors Confidence Index for both current conditions and future conditions improved for all housing types. Builder confidence, as measured by the National Association of Home Builders/Wells Fargo Housing Market Index, was unchanged in March and remained at a level indicating homebuilders continue to be positive about the housing market.

***NOTE**: This newsletter does not constitute legal, valuation, tax or any other type of consulting advice. It is offered as an information service to our clients and friends. For specific legal and accounting issues, it is advisable to seek professional advice. We welcome the opportunity to discuss any specific valuation issues that you may have.*

Valuation Services, Inc. (VSI) is one of the premier business valuation firms based in the Washington, DC area that specializes in valuing private, closely-held businesses. We have valued private entities owning real estate and operating businesses with hundreds of thousands to billions of dollars of asset value. In addition, VSI has valued other assets like intangible assets, notes receivables, law suit claims, tenant-in-common interests, and large blocks of publicly traded stock.

VSI has a staff of professionals that prepares and supports valuations on a full-time basis. Our team of professionals handles various types of valuations and has a history of successfully defending as expert witnesses before the IRS and in many different courts. Our valuations are used for a variety of reasons—i.e., estate planning and administration, ESOPs, litigation support, succession planning, mergers and acquisitions, bankruptcy, financial reporting, and Section 409A.

For more information please contact:

Craig Stephanson, CPA, CVA
Managing Director
571-447-5401
craig@valuationservice.com

Jeff Bae, JD, CVA
Managing Director
571-447-5402
jeff@valuationservice.com

3000 Wilson Boulevard, Suite 220 • Arlington, VA 22201 • (571) 447-5400

1177 Avenue of the Americas, 5th Floor • New York, NY 10036 • (646) 452-7056

801 Brickell Avenue, Suite 900 • Miami, FL 33131 • (786) 375-5066

www.valuationservice.com