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111 SW Columbia Street, Suite 750 | Portland, OR 97201-5814
(503) 479-8200 | info@bvresources.com
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Vol. 27, No. 5, May 2021

BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

New Study Analyzes Earnout Data in DealStats

By Brian Wendler and Rebecca Crowley, National Business Valuation Services (Dallas, Texas, USA)

The purpose of this article is to focus on the main part of a presentation we recently gave that discussed data on earnouts contained in BVR's DealStats database.[1] The reason for our interest in this topic is our firm, NBVS, and our related M&A firm (National Transaction Advisors Inc.) are heavily involved in M&A advisory services to entrepreneur and family-founded businesses.

1 Tips and Techniques—How to View/Value/Sell Poorly Performing Businesses From an M&A and a Transaction Standpoint, a presentation at the American Business Appraisers and BVR Annual Key Issues Update online conference, Oct. 29, 2020; recording available at sub.bvresources.com/DLC.asp?WebinarID=812.

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Company-Specific Risk Is Not All That Specific

By Peter J. Butler, Valtrend (Eagle, Idaho, USA)

Is anything "company-specific" per se? Company-specific risk is not an ideal name for this risk. All firms face company-specific risks, many of which are somewhat similar across industries and companies. For example, how many firms have you valued that had to deal with the risk of customer concentration? How about dependence upon key personnel? Have you ever valued a company that had to deal with dependence on one (or just a few) suppliers?

If you have valued one company with one of these risks, you likely have valued many others. Thus, this risk is not all that unique or company-specific per se. I have never applied a company-specific risk premium (CSRP) to a subject company

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because I have found a risk to be so unique or so specific to that company only.[1]

If It's Not That 'Company-Specific,' What Is It?

So, for what it's worth, why have I ever applied a CSRP to my discount rate—if it is not all that unique per se? Because the premium that we are talking about is actually unsystematic risk. Definitions and semantics matter. Finance textbooks use the term "unsystematic"[2] and generally claim the following:

> Systematic risks (uncertainties regarding GDP, interest rates or inflation, for example) are ones that influence a large number of assets, each to a greater or lesser extent. On the other hand, unsystematic risk is one that affects a single asset (or a small group of assets) and can be diversified away.

Most academic textbooks generally do not use the term "CSRP," which has become ubiquitous in business valuation lexicon[3]—unfortunately.

Why Write Another Article on Company-Specific Risk?

A NACVA *QuickRead* article in late December 2019 stated:

> A typical range for the application of the CSRP is one percent to 10 percent. *However, it is not uncommon for an analyst to apply a CSRP of*

1 This, of course, is not to say that "company-specific" risk is the exact same from company to company. In fact, the impact of this risk can vary dramatically from company to company. "Key" personnel, for example, may be more key for some companies than for others. Obviously, the key-person risk for one company has no influence on another company, which may have its own key-person risk. From this perspective, the risk is unsystematic but not all that "unique" or "company-specific" per se.

2 Or idiosyncratic.

3 I also have used the term "CSRP" in many previous writings and presentations on the topic.

> *zero percent or even a negative percentage. In a zero percent or negative percent CSRP selection scenario, the implication is that the subject company provides less of an investment risk than an investment in a general equity stock market participant.*[4] (Emphasis added)

With all due respect to business valuation textbooks and instruction on this topic, I believe the above quote may be a common misconception in the industry. Unsystematic risk can never be negative or even 0%. Apple Inc.[5] (Ticker: AAPL) has (unpriced) unsystematic risk. Certainly, your small, privately held subject company, therefore, also has (in this case, priced) unsystematic risk.

If it is your determination that the subject company provides less of an investment risk than an investment in a "general equity stock market participant," then "simply" select a lower beta (and/or alleged size premium) than the general equity stock market participant—but never apply a 0%, or negative, unsystematic risk premium. How can a privately held company have a 0% (or negative) premium—if every single publicly traded stock has (unpriced) unsystematic risk? After all, we call it "risk" for a reason.

Accepted Theory

Systematic (beta) risk is the only risk that is priced for a general equity stock market participant since the participant's unsystematic risk can easily be diversified away in a well-diversified portfolio. Moreover, well-diversified portfolios are easy to come by in the publicly traded equity markets with zero commission trades and the explosion of exchange-traded and index funds.

However, it is not so easy to diversify this risk away for the typical hypothetical willing buyer/willing seller in the private markets. Typically, an investment in a (small) privately held company is one of, if not the largest, investments in one's portfolio. Simply stated, a private-business owner/prospective buyer of a private business is/will not be perfectly diversified, which is required for only systematic risk to be priced. Thus, your private subject company has priced, unsystematic risk (i.e., not a negative "premium" or even 0%) associated with an investment in its equity.

If you use Total Beta, there is no need to select the subject company's beta, the alleged and dubious size premium, and then completely guess at the CSRP.

The Real World

It is commonly thought that the following is axiomatic:

> It is the risk of the investment itself, not the investor, that matters.

Why does every academic textbook state this, or words to that effect?

Simply stated, academia focuses on publicly traded stocks and assumes that every investor is perfectly diversified (to use the CAPM). If everyone is perfectly diversified, or can easily become so, then all investors are homogeneous and, therefore, irrelevant from an individual perspective. Thus, beta (in the CAPM) is all that matters.

This is not the world in which private markets typically operate, however. Therefore, the private company investor—in the fact that he or she does not own the "market portfolio" and is not perfectly diversified—matters, and matters greatly. So, academia and the public markets assume everyone

4 quickreadbuzz.com/2019/12/11/business-valuation-kirkland-henriquez-issues-in-estimating-2.

5 The largest company by market capitalization listed on a U.S. stock exchange (at more than $2 trillion) as of the writing of this article.

is the same, perfectly diversified investor and, therefore, only pricing systematic risk. On the other hand, in many instances, business appraisers and private markets should assume marginal buyers are not perfectly diversified and, therefore, price systematic as well as unsystematic risk.

The Way Forward

One can use total beta (TB), defined as the standard deviation of a stock/standard deviation of the market, to calculate the general equity stock market participants' total cost of equity (TCOE), or their unsystematic risk premium—if necessary.[6] (As a reminder, since unsystematic risk can be easily diversified away, do not use TB and TCOE when analyzing publicly traded stock for investment purposes). Then, and only then, can the analyst carefully compare the subject company to the guidelines to select a TCOE or unsystematic risk premium for the subject company since, as pointed out, this risk is not about any unique or "company-specific" risk per se.

TCOE = risk-free rate + TB*(equity risk premium)

Notice that beta has been replaced with total beta in the CAPM.[7]

6 I have been using total beta for the last 15 years and introduced the Butler Pinkerton Calculator in 2007. As most are aware, its use has been allegedly controversial—despite strong testimonials from finance Ph.D.s and many well-respected appraisers. As one will see in this article, total beta stems from the CAPM and modern "portfolio" theory. I did not invent the equations or the assumptions used here. In other words, there should be no controversy—if you accept the CAPM as a useful (but, of course, not perfect) tool to assist in the development of a cost of equity.

7 Professor Aswath Damodaran of New York University first introduced the TCOE equation to the business valuation community in the late 1990s—more than 20 years ago. Total beta was introduced in 1981 in the "The Beta Quotient: A New Measure of Portfolio Risk," written by Robert C. Camp and Arthur A. Eubank Jr., published in the *Journal of Portfolio Management*. *(Note: Total beta was referred to as the "beta quotient" in the article).*

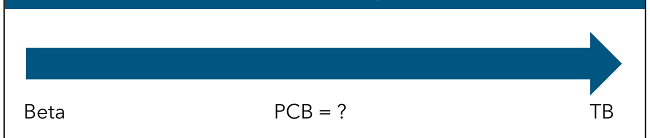
It's a simple adjustment based on modern portfolio theory (MPT). Thus, while we all understand that CAPM has its issues, if you accept this ubiquitous cost of capital model, which is taught in all universities (with a finance program) and is the most popular choice on Wall Street, no one should have any issues with using TB and the TCOE for privately held company valuation. (Please see discussion of a simplified, two-asset portfolio below and the resultant private company beta (PCB) as a supplement to TB's use.)

If you use TB, there is no need to select the subject company's beta (or industry risk premium in the buildup method), the alleged and dubious size premium, and then completely guess at the CSRP. So, you either have to select and defend three selections (beta/industry risk premium, the size premium, and the CSRP) in the buildup method or just TB—and TB has market-based evidence, unlike the completely qualitative estimate of a CSRP. By qualitatively estimating the CSRP, analysts may be essentially guessing at the TCOE—the ultimate conclusion. Thus, I believe the choice is simple. Use publicly traded stock data to its maximum potential—which should include both beta and TB—at a minimum as a check on the ubiquitous buildup method.

The Beta Spectrum

Let's take a look at these metrics on the spectrum in Exhibit 1 to help explain the theory in more detail.

Exhibit 1. Beta Spectrum



On the left-hand side of the arrow, let's assume that an investor is perfectly (or can rather easily be "perfectly") diversified. At this point on the arrow, the only beta that matters (in the CAPM) would be the company's beta, whatever that is.

On the right-hand side of the arrow, let's assume that the investor has/will have a one-asset portfolio (i.e., the private company) and has pricing power. Here, the only beta that matters is the company's TB (using CAPM theory), whatever that is.

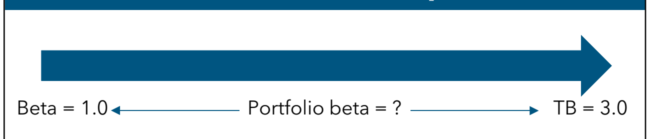
What about points on the spectrum between the two extreme points? After all, this is the proverbial "real world." We have never met a private (small) business owner/hypothetical willing buyer who is perfectly diversified or really anywhere close to it, nor have we met a (small) private business owner/hypothetical willing buyer whose entire portfolio is a privately held company.

Let's call the appropriate point on the arrow (wherever it is) the company's PCB—the beta that a less than perfectly diversified (but not completely undiversified) investor would require to invest in the privately held company.

We will use MPT to calculate this pertinent beta.

Let's look at another spectrum in Exhibit 2.

Exhibit 2. Another Beta Spectrum



One might assume that, if 50% of an investor's worth is tied up in the privately held business and the other 50% is invested in the "market portfolio," the portfolio beta would be the average of the betas (1.0 = the market beta and the appropriate TB (let's say 3.0, which may be a "typical" TB for a privately held company)) equal to 2.0. But that assumption is incorrect. Let's see why.

The Two-Asset Portfolio

In this two-asset portfolio, we have our private company and we have the market portfolio. Let's define the following:

- Б is the standard deviation of the respective investment;
- P stands for the investor's portfolio in this two-asset portfolio;
- ω stands for the weight of the particular investment in the two-asset portfolio;
- PC stands for private company;
- MP stands for market portfolio; and
- ṕ is the correlation of the private company with the market portfolio.

Thus, if we assume the standard deviation of the market portfolio is equal to 20%, a "typical"[8] historical standard deviation of the S&P 500, for example, we can calculate the following:

> The standard deviation of the private company is equal to 60%.

$$\text{б}_{PC} = TB*\text{б}_{MP} = 3.0*20\% = 60\%$$

We can also calculate the correlation of the private business (Asset No. 1, where we assume that its beta is equal to 1.1 (a "typical" private company beta)) with the market portfolio (Asset No. 2):

$$\acute{\rho} = beta/TB = 1.1/3.0 = 0.37$$

… since TB also equals beta/ṕ.

Now we can calculate the standard deviation of our two-asset portfolio, using MPT:

$$\text{Б}_P = ((\omega_{PC}{}^2)(\text{б}_{PC}{}^2) + (\omega_{MP}{}^2)(\text{б}_{MP}{}^2) + 2(\omega_{PC}*\omega_{MP}*\acute{\rho}*\text{б}_{PC}*\text{б}_{MP}))^{\wedge.5}$$

$$\text{Б}_P = ((.5^2)(.6^2) + (.5^2)(.2^2) + 2(.5*.5*.37*.6*.2))^{\wedge.5} = 34.93\%$$

8 Using the S&P 500 annual stock returns from 1928 through 2019 correlates to an annual standard deviation of 19.16%.

So, what is the portfolio beta for the two-asset portfolio?

$$\text{Beta}_P = Б_P/б_{MP} = 34.93\%/20\% = 1.75$$

which is less than 2.0 (the simple average of the respective betas) due to lack of perfect correlation (see 0.37 above, not 1.0) between the two assets, which is the essence of diversification. This beta can be considered a weighted average beta of the two-asset portfolio.

Thus, the PCB is calculated as follows:

$$\text{Beta}_P = \omega_{MP} * \text{beta}_{MP} + \omega_{PC} {}^* \text{PCB}$$

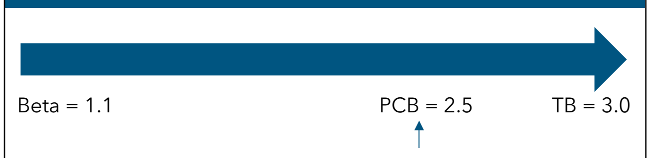
$$1.75 = .5*1.0 + .5*\text{PCB}$$

$$\text{PCB} = 2.50$$

The 'Dominance' of TB

Now, notice where this is on the beta spectrum (See Exhibit 3)?

Exhibit 3. Location of PCB on Beta Spectrum



Note that TB dominates in the fact that the PCB is greater than 2.05 ((3.0 + 1.1)/2).

Thus, it is easy to see why private-company appraisers should not only "know" what their subject company's appropriate beta is (assuming they are using the CAPM or modified CAPM), but it is equally important to "know" their private company's TB, since it is the dominant beta.

For more "evidence" regarding the dominance of TB in private-company valuations, please see Exhibit 4, which uses all of our previous assumptions but changes the importance, or the relative weighting, of the two assets.

Resultant TCOEs

Use guidelines to help select your company's beta and TB, then determine the appropriate PCB, if necessary. In the above example, not an atypical representation of a privately held company, let's see what the TCOE may look like using a risk-free rate (rf) of 2.1% and an equity risk premium (ERP) equal to 5.25%.

Certainly, the range of the (bolded) costs of equity in Exhibit 5 appears to be reasonable for many privately held companies.

Conclusion

Since CAPM is the most popular model on Wall Street for the determination of the cost of equity

Exhibit 4. Changing Importance or the Relative Weighting of the Two Assets

Weight of Private Company in Two-Asset Portfolio	PCB	Comments
0.1%	1.10	PCB = beta
1%	1.14	
10%	1.48	
20%	1.81	
30%	2.09	Approximate average of beta and TB = 2.05
40%	2.31	
50%	**2.50**	"Typical" range of estimated weight of private company in portfolio: 50% to 100%
60%	**2.64**	
70%	**2.75**	
80%	**2.85**	
90%	**2.93**	
100%	**3.00**	PCB = TB

Exhibit 5. Using a Risk-Free Rate of 2.1% and an ERP of 5.25%

Weight of Private Company in Two-Asset Portfolio	PCB	TCOE
0.1%	1.10	7.9%
1%	1.14	8.1%
10%	1.48	9.9%
20%	1.81	11.6%
30%	2.09	13.1%
40%	2.31	14.2%
50%	**2.50**	**15.2%**
60%	**2.64**	**16.0%**
70%	**2.75**	**16.5%**
80%	**2.85**	**17.1%**
90%	**2.93**	**17.5%**
100%	**3.00**	**17.9%**

for publicly traded stocks, then TB (and/or PCB) and the resultant TCOE (CAPM's natural extensions for privately held companies) also should be part of every appraiser's proverbial toolbox–at a minimum, as a reasonableness check on other cost of capital sources–to maximize the potential of the data you already have at your fingertips. ◆

Peter J. Butler, CFA, ASA, is founding principal of Valtrend (Eagle, Idaho). He has championed a more quantitative and empirical approach to developing the cost of capital, which is embodied in the Butler Pinkerton Calculator, which he invented and co-developed. For more information, go to bvresources.com/products/butler-pinkerton-calculator.

Earnout Data in DealStats

... continued from front page

As in other recessionary periods, we have experienced that the buying and selling of businesses (hereinafter referred to as "deals," "transactions," "transfer of ownerships," and "buyouts") have been cancelled, delayed, and/or drastically restructured. By restructuring, we are referring to either large seller notes and/or separate contingent or performance earnouts (hereinafter referred to as "contingent consideration and or earnouts"). And, as we have learned this time around, this recession and economic downturn are much different—in short, it's a pandemic with a lot of government controls. For many business owners and families, their businesses are no longer as valuable as they were pre-COVID-19. On the other hand, we know and have valued some businesses that have thrived.

Nonetheless, plenty of business owners still want to sell due to a multitude of reasons: health, burnout, partner disputes, divorces, and death. You name it; we've seen it all during this current pandemic, and we saw it in other recessions. But life goes on. So, as we learned in previous recessions, in order to get deals done today and going forward, sellers and buyers will need to be flexible in structuring the transaction. Especially for businesses that have not performed well, that have suffered lower earnings and cash flow, during this pandemic, we anticipate that many of those transactions will need to be structured with some form of contingent consideration or earnouts.

So, in order to, as they say, come down the learning curve as quickly as possible, we wanted to see whether the BVR DealStats database (formerly Pratt's Stats), which is one of the largest business transaction real-world databases of its kind, could explain or predict perhaps some of the following, keeping in mind that this pandemic has affected some industries far greater (with outright stay-at-home orders, lockdowns, and lockouts) than a "normal" recession would have impacted:

1. In recessionary periods, which industries might experience the greatest number of earnouts, i.e., which industries were more likely to experience an earnout?

2. What percentage (%) of MVIC or enterprise value did the earnout represent?

3. Was there any relationship between the size of the transaction in terms of MVIC or enterprise value and the occurrence of an earnout?

Before we begin, here are a couple of definitions of earnouts.

In a fair value context, an earnout is defined as: "An obligation of the acquirer to transfer additional assets or equity interests to the former owners of the acquired as part of the exchange for control of the acquired if specified future events occur or conditions are met." (Source: FASB ASC 805).

According to Wikipedia, earnout (or earn-out) "refers to a pricing structure in mergers and acquisitions where the sellers must 'earn' part of the purchase price based on the performance of the business following the acquisition."

Earnouts and DealStats

As heavy users of the DealStats database in our business valuation and M&A advisory practices, and specifically in the valuation of earnouts in the context of purchase price allocations, we had noticed that the DealStats transaction reports show only limited information. By further explanation, the transaction notes will give information on earnouts, but the earnout value itself is excluded from the market value of invested capital (MVIC) and is not shown in the purchase price allocation section of the PDF transaction report. We concur with the way BVR is handling earnouts because you would not want to add in the potential earnout when it may or may not be earned.

Although it is not easy to find earnout information from the regular transaction reports, Business Valuation Resources does record earnout information when this information is available from the buyers and sellers.

Fair Value vs. Full Value Earnouts

BVR provided us with both fair value earnouts and full value earnouts, depending on the information in the transaction documentation. The differences between the two types of earnout values are as follows:

- *Full value earnout*—This is the full amount of the earnout available to the seller. So, if the terms of an earnout are $500,000 each year for three years, the full value would be $1,500,000.

- *Fair value earnout*—This is the fair value as of the transaction date, which would generally be the present value of the earnout determined using valuation techniques. It would be lower than the full value of the earnout because it is stated at present value and the risk of not meeting the earnout target(s) is considered. Earnouts are required to be stated at fair value on audited financial statements.

The fair value earnout requires more rigorous calculations, and an outside valuator often determines the value during an audit. Unsurprisingly, the proportion of fair value earnouts increased as the company size (determined by MVIC) increased.

Earnouts by Type of Acquirer/Target

The earnout information BVR provided was from acquisitions by both public and private companies of public and private targets. The percentages of total earnouts using combination of target and acquirer are shown in Exhibit 1.

The most common combination was a public buyer and a private target. Based on our experience valuing earnouts and working with both public and private buyers, we believe this is due to a number of factors including the following:

- Public buyers need to have audited financial statements due to regulatory requirements, so earnout values would be disclosed. Private buyers might not disclose the earnout values, especially if a formal purchase price allocation was not done (we have seen that sometimes the earnout liabilities are completely left off of financial statements of private companies).

- The SBA does not allow earnouts as part of the purchase price transactions for 7(a) small-business loans. Many private buyers rely on SBA financing to purchase businesses, while public buyers would be buying much larger companies usually too large to qualify for SBA loans.

- Public buyers are better able to take on the risk of purchasing an unprofitable company (say, software or biotechnology) or to fund dynamic growth, but, in exchange for this, they require future targets to be met. Financial or private buyers often need to take an owner/officer's salary from a business and would not be able to afford to run an

Exhibit 1. Percentages of Total Earnouts in DealStats

Target	Acquirer	% of Total Earnouts
Public	Public	6.25%
Private	Public	68.37%
Public	Private	0.27%
Private	Private	25.13%

unprofitable company in hopes of future success.

Earnout Information by Date

Exhibit 2 shows earnout data from DealStats by year, beginning in 2007 and ending in 2020.

Some observations about the data in Exhibit 2:

- The weighted average fair value earnout over the 14 years is 19.9% of MVIC compared to a weighted average full value earnout of 25.5%. It is understandable that fair value earnouts would be lower than full values due to the more accurate calculation of fair value using present value and models that consider the risk of not meeting targets. The full value is just the total possible value of the earnout without regard to the likelihood it would be earned (risk of not meeting targets) or time value of money.

- The median earnout percentages were lower than the mean earnout percentages for both fair value and full value earnouts.

- There does not appear to be any overall trends by year, although there were somewhat more earnouts between 2014 and 2019 compared to earlier years (2020 data were only for a partial year). However, considering the time that it does takes to work out of a recession and restore business confidence, we do see an uptick in earnouts immediately following the last great recession, in both 2010 and 2011. Maybe this uptick in earnouts can be attributed to companies that were struggling to rebound, to fund future growth, or that needed an exit for the variety of reasons already mentioned. Next, let us review earnouts by MVIC size.

Exhibit 2. DealStats Earnout Data by Year

	Earnout Fair Value			Earnout Full Value		
Year	Count # Trans	Median Fair EO % of MVIC	Average Fair EO % of MVIC	Count # Trans	Median Full EO % of MVIC	Average Full EO % of MVIC
2020	24	7.50%	16.13%	11	24.00%	30.55%
2019	50	16.00%	21.70%	49	19.00%	21.84%
2018	41	7.00%	16.22%	42	21.50%	27.52%
2017	43	13.00%	17.47%	44	25.00%	26.68%
2016	45	15.00%	20.93%	39	19.00%	26.87%
2015	37	11.00%	16.30%	48	17.50%	27.31%
2014	42	20.50%	26.57%	37	17.00%	22.78%
2013	24	21.50%	26.42%	26	16.50%	22.08%
2012	17	7.00%	11.41%	26	19.00%	23.73%
2011	34	10.50%	17.15%	29	32.00%	30.55%
2010	30	10.00%	14.70%	29	21.00%	27.97%
2009	21	24.00%	25.19%	23	25.00%	26.70%
2008	14	21.00%	32.64%	35	19.00%	27.69%
2007	0	NA	NA	9	29.00%	30.22%
Totals/ Weighted Avg	422	13.9%	19.9%	447	20.4%	25.5%

Earnout Information by Company Size

Exhibit 3 shows earnout data by MVIC value, from companies with MVIC of between $1 million and $5 million to companies with MVIC of between $500 million and $1.0 billion. The number of transactions is lower than the number of transactions by year presented above because some yearly transactions did not have MVIC in the requested value ranges.

Some observations about the data in Exhibit 3:

- Smaller companies (with lower MVIC) generally had larger earnouts as a percentage of MVIC. The smallest companies (those with $1 million to $5 million MVIC) had the largest median and average earnouts, with the fair value earnouts especially high for the smallest companies (both median and average above 30% of MVIC).

- Almost a third of all full value earnouts were for companies with MVIC between $1.0 million and $5.0 million and over half for companies with MVIC at or below $15 million.
- We suspect that the reason why the smaller companies would have the greater number of earnouts is most smaller company owner(s) have a high degree of personal and/or professional goodwill that may not be that easily transferred. Also, there may be circumstances where, with smaller businesses, there is a greater likelihood of customer concentration risk.
- Both fair value and full value earnout percentages were very low for companies with MVIC of $100 million or higher.

Exhibit 3. DealStats Earnout Data by Company Size (MVIC)

	Earnout Fair Value			Earnout Full Value		
MVICRange (In Millions)	Count # Trans	Median Fair EO % of MVIC	Average Fair EO % of MVIC	Count # Trans	Median Full EO % of MVIC	Average Full EO % of MVIC
1.0 to 5.0	41	33%	35%	97	26%	30%
5.1 to 10.0	38	16%	20%	49	21%	25%
10.1 to 15.0	31	18%	24%	33	25%	28%
15.1 to 20.0	28	19%	26%	21	20%	27%
20.1 to 25.0	18	17%	24%	11	18%	22%
25.1 to 50.0	64	15%	22%	59	17%	24%
50.1 to 100.0	53	13%	16%	27	18%	21%
100.1 to 200.0	42	9%	15%	21	12%	17%
200.1 to 500.0	45	5%	9%	22	9%	13%
500.1 to 1,000.0	25	6%	11%	14	12%	17%
Totals/ Weighted Avg %s	385	15%	20%	354	20%	25%

Earnout Information by Industry

Exhibit 4 shows earnout data by industry. The totals are again below the number of earnouts by year because not all targets were in the selected industries (which we had selected based on our experience with earnout valuations and our M&A practice).

Some observations about the data in Exhibit 4:

- Manufacturing accounted for the largest number of transactions with earnouts by far, at over a third of both fair value and full value

Exhibit 4. DealStats Earnout Percentages by Industry

	Earnout Fair Value			Earnout Full Value		
Industry	Count # Trans	Median Fair EO % of MVIC	Average Fair EO % of MVIC	Count # Trans	Median Full EO % of MVIC	Average Full EO % of MVIC
Manufacturing	113	13%	19%	115	18%	26%
Biotechnology-Pharm	58	23%	26%	28	25%	35%
Software	50	9%	19%	46	20%	27%
Finance and Insurance	34	12%	19%	18	17%	23%
Wholesale Trade	23	13%	19%	19	19%	24%
Construction	14	10%	13%	28	22%	25%
Natural Resource	7	4%	3%	6	8%	11%
Limited Service Restaurants	2	5%	5%	0	NA	NA
Event Planners	1	37%	37%	0	NA	NA
Hospitality-Hotels	1	27%	27%	0	NA	NA
Totals/ Weighted Avg %s	303	13.9%	19.7%	260	19.3%	26.3%

earnouts. One factor that could contribute to the large number of earnouts for manufacturing companies is the ease of setting and measuring defined targets (number of units sold; number of customers retained; satisfaction ratings) that do not rely on profitability.

- Earnouts for the biotechnology-pharmaceutical industries were higher as a percentage of MVIC than for any other industry. This is likely due to the importance of hitting regulatory targets, which are also easily measured (hit-or-miss and the granting of licenses).

- The software industry also had a large number of earnouts. In our experience, buyers in this industry often want to keep the sellers, who were also instrumental in developing the software, on/in managerial/consulting roles. This may also be true for manufacturing companies, especially those with sellers who have long-standing relationships with customers and vendors. An earnout provides an incentive for a seller to help with the ongoing success of a company.

Business valuation experts and M&A advisors will have to become more familiar with earnouts in this current economic and deal environment. When an owner says that he or she does not believe in earnouts, at least this information will show that they do occur, and what kind of parameters (percentage of full earnout value or MVIC) may be reasonable. If you are in the deal business, we hope these data will help you. The goal of any M&A or buy/sell process is for the advisor to accomplish the client's goals and objectives. We look forward to updating this study periodically in the future. ◆

***Brian Wendler,** ASA, CPA-ABV, ABAR, CMEA, CM&AA, is a Texas real estate broker and founder of National Business Valuation Services (a business valuation and machinery and equipment appraisal firm) as well as National Transaction Advisors. He is currently in his second term as the president of the Texas Association of Business Brokers (TABB) and is on the Advisory Council of the Alliance of Mergers & Acquisition Advisors (AM&AA). **Rebecca Crowley,** CPA, is a senior valuation analyst with NBVS, formerly with KPMG. I would also like to thank senior analysts **Paige Browne** and **Bill Lux** for their review and critique.*

Ask the Experts

Q: *In a litigation matter, I did a multiperiod DCF and then found out the court prefers to see a single-period capitalization of cash flow. Is it appropriate to simply convert my DCF to a CCF in my report?*

A: Valuation experts should be very concerned about providing their analysis in a format that the judge is most comfortable with. A good strategy to consider in this case would be to show both the DCF and CCF and use it as an opportunity to educate the judge, who may have trouble with the speculative nature of a DCF. You could show your DCF analysis and the reasons for doing it and then put it into a single-period capitalization context. You can point out that the CCF uses "tried-and-true" earnings and then explain the discount rate and implied growth rate.

Source: Valuing Enterprise Cash Flows; BVR webinar, March 17, 2021; Z. Christopher Mercer (Mercer Capital) and Travis Harms (Mercer Capital); available at sub.bvresources.com/DLC.asp?WebinarID=1639.

The Strategic Premium: An Inside Look at M&A Prices

By Jim Horvath, ValuQuest Limited (Canada)

Editor's note: "Control" value is traditionally thought of in terms of two levels: (1) the value associated with de jure and de facto control conferred by an equity ownership interest per se, which represents an incremental value above that of a marketable minority interest; and (2) the value resulting from a combination of such control and the synergies available to the controlling interest holder, which result from the combined resources of controlling interest holder and those of the controlled entity. This article points out that synergistic/strategic value should not be combined into one level. Some buyers pay a "strategic premium" that propels strategic value to the very top level of the value chart and well in excess of the expected synergistic value. The author uses real-world examples to illustrate this concept.

As an introduction, I would like to offer these quotes:

- "Buyer and seller motivations may also play an important role in interpreting purchase price. For example, a strategic buyer may 'stretch' to pay a higher price for an asset if there are substantial synergies to be realized and/or the asset is critical to its strategic plan ('scarcity value')."[1]

- "Synergies represent tangible value to the acquirer in the form of future cash flow and earnings above and beyond what can be achieved by the target on a stand-alone basis. Therefore, the size and degree of likelihood for realizing potential synergies play an important role for the acquirer in framing the purchase price for a particular target. Theoretically, higher synergies translate into a higher potential price that the acquirer can pay."[2]

It is not unusual to see strategic premiums paid in the merger and acquisition (M&A) marketplace. Strategic buyers—buyers motivated by overall business strategy considerations and *massive* financial returns—often pay significantly more than typical market participants. Both are known to pay premium prices based on an estimate of the value increment created by synergistic benefits. Still, strategic buyers often pay uniquely high prices, which seem difficult to explain. I often see market participants pay a premium of up to 50% higher than prices typically paid by financial buyers, i.e., buyers motivated primarily by financial returns alone. These financial gains usually result from higher revenue growth and/or lower operating costs. But there is a group of special-interest buyers that specifically considers unique synergistic benefits from an M&A transaction, which I will refer to as strategic buyers and some defensive buyers. The latter (a subset of strategic buyers) sometimes acquire "defensive intangible assets" with no intent to use those intangibles other than to block competitors from using them. Strategic buyers and some defensive buyers will sometimes pay a multiple of two times or more than financial buyers are willing to pay.

Practice tip. "Synergy, the increase in value that is generated by combining two entities to create a new and more valuable entity, is the magic ingredient that allows acquirers to pay billions of dollars in premiums in acquisitions."[3]

My experience shows that the highest premiums are paid by strategic buyers who have uniquely synergistic, value-enhancement opportunities.

1 Joshua Rosenbaum and Joshua Pearl, *Investment Banking—Valuation, Leveraged Buyouts, and Mergers & Acquisitions,* 2nd edition, Hoboken, N.J., John Wiley & Sons Inc., 2013, p. 162.

2 Ibid 1, p. 185.

3 Aswath Damodaran, "The Value of Synergy." Paper dated October 2005, p. 3; people.stern.nyu.edu/adamodar/pdfiles/papers/synergy.pdf.

I refer to these transaction prices as having taken place at a strategic premium price, which is widely out of line with prices paid by typical synergistic buyers. Transactions at strategic premium prices most often compound valuation challenges because an outside analyst will not be able to determine what motivated a buyer to pay a strategic premium.

Strategic Buyers

A few observations on strategic buyers:

- The greatest strategic buyers of today are from China;
- The greatest strategic buyers of 2000 to 2015 were from the EU and the U.S.; and
- The greatest strategic buyers of the 1980s were from Japan.

In the 1975-to-1990 period, I first saw strategic premium prices being paid during my work on both buy- and sell-side assignments for publishers of newspapers, magazines, books, and Japanese corporations. Select global and national publishers would occasionally pay up to four times (4.0x) the price of financial buyers and 2.5 to 3.2 times the prices being offered/paid by other market participants. After taking into account strategic buyer synergies, the global publisher's payback period was up to 20% less than what financial buyers realized.

Over the past few years, I have been working primarily in China for Asian buyers, often seeing hefty premiums paid. An excellent example of a strategic premium was seen in 2020, where a very successful Chinese enterprise paid $90 million for a foreign company, of which $84 million was paid for intellectual property, comprised primarily of technology protected by a combination of patents and trade secrets. The transaction price was over 100 times (100x) the average EBIT for the previous three years. EBITDA and EBIT were not significantly different, as it was not a capital-intensive business and had no debt. The target's revenues and earnings for the prior three years grew at about 1% to 3% above the rate of inflation. On an "as-is" basis, revenue and earnings growth for the ensuing five years was expected to average about 3% to 5% per annum. Although unobservable to outside analysts, as a financial advisor to the purchaser, we learned that the large strategic premium was paid to ensure the transaction would be completed quickly and with a high degree of certainty. The acquirer planned to utilize the technology in its Chinese marketplace, where it had a large, well-established customer base. After taking into account China-marketplace synergies, the effective price paid was eight times EBITDA. So, strategic premiums are generally characterized by *expected strong synergies that are often observable only to the acquirer*, who I will term a strategic buyer.

In another case of the past two years, a south Asian company paid 3.5 times more than would financial buyers for an equity interest in a marginally global pharmaceutical company with no significant presence in Asian markets. From what I've seen, most strategic buyers with the ability to capitalize on the large Asian markets—especially the China and India markets—have been successful in their endeavors. This suggests one of the primary objectives of strategic buyers is to *redeploy resources into markets where there are expected competitive advantages and superior expected market growth.*

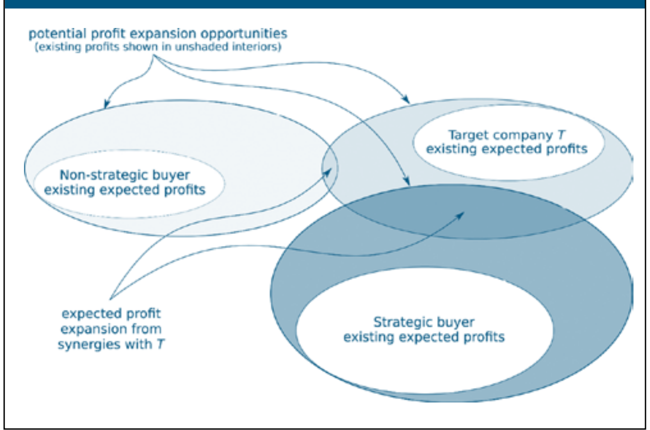
In yet another case, a strategic buyer offered four times (4x) the *going-concern basis stand-alone value* of a technology company, only to lose out to another strategic buyer who doubled the offer and purchased the target at eight times (8x) *going-concern basis stand-alone value. The price paid is investment value* (*investment value* is the value of an investment to a specific individual or entity and reflects the unique objectives and circumstances of that owner.) The strategic asset sought was again intellectual property, and both strategic buyers were from Asia. Although I have worked for many billion-dollar companies, these premiums can only make me smile. They are massive, but the returns they generate for the buyers are many times more massive. These cases suggest that another common objective of strategic buyers is the acquisition and control of intellectual property, either for their positive synergistic benefits leading to expected product improvement, revenue, and profit growth, or their synergistic defensive benefits expected to result in the protection of the existing intellectual property, products, revenues, and profits of the strategic buyer.

Differentiating Strategic Value, Synergistic Value, and Net Acquisition Value

I see strategic value as having a slightly different meaning than the standard concept of synergistic value. I see strategic value as a *massive* synergistic value that makes the acquisition substantially imperative for the strategic buyer and, often, an existential imperative for the strategic buyer. To differentiate between strategic value and typical synergistic value, it is helpful to consider the diagram in Exhibit 1.

As shown in Exhibit 1, both the strategic buyer and the nonstrategic buyer (such as a typical market participant) obtain expected synergy benefits from the contemplated acquisition. The strategic buyer receives massive expected

Exhibit 1. Strategic vs. Synergistic Value



benefits both in absolute terms and relative to its overall potential expansion opportunities. Again, strategic buyers regard such acquisitions as existential imperatives.

To further differentiate, we'll look at some definitions and a measure of net acquisition value. The first two definitions are from *The International Business Valuation Glossary* (draft as of Dec. 14, 2020), and the third by Shannon Pratt (2003):

> "*Synergies*—used mostly in the context of mergers and acquisitions, the concept that the combined value and performance of two (or more) businesses will be greater than the sum of the separate individual parts. In the context of developing prospective financial information, synergies refer to the difference between the assumptions used to estimate cash flows that are unique to a business enterprise and the assumptions that synergistic buyers would use.
>
> *Synergistic Value*—the result of a combination of two or more assets or interests where the combined value is more than the sum of the separate values."[4]
>
> "*Strategic Value (Synergistic Value)*—A strategic or synergistic value reflects added benefits to a particular acquirer because of synergies with the acquiree. That is, it is a price or potential price reflecting all or some portion of the value of synergistic benefits created through the combination of the respective entities for which a buyer might be willing to pay. Such benefits could include, for example, increasing market share, reducing costs by combining operations, and/or raising prices by eliminating a competitor.
>
> "Synergistic value generally reflects some added value above fair market value. Because it demonstrates the value of benefits available

4 The *International Business Valuation Glossary* (draft as of Dec. 14, 2020). Posted on the websites of NACVA, CBV, ASA, AICPA, and RICS.

> to a particular buyer, it is usually considered to fall within the concept of investment value."[5]

Pratt also states, "[I]t is not uncommon that value under one definition may be twice as much (or more) as value under another definition for the same property on the same date."[6] I have found this to be true. In the strategic premium M&A deals I have worked on, the transaction prices, which I refer to as strategic value, were more than twice the typical, expected synergistic value.

Patrick A. Gaughan[7] measures the effects of synergistic benefits by calculating the net acquisition value (NAV) through the following equation and a reorganized form of it:

$$NAV = V_{AB} - [V_A + V_B] - P - E$$

$$NAV = [V_{AB} - (V_A + V_B)] - (P + E)$$

where:

V_{AB} = the combined value of the two firms,

V_A = the value of A,

V_B = the value of B,

P = the premium paid for B, and

E = the rexpenses of the acquisition process.

5 Shannon Pratt, *The Lawyer's Business Valuation Handbook: Understanding Financial Statements, Appraisal Reports, and Expert Testimony*, American Bar Association, 2003.

6 Ibid. 2, chapter 1, p. 3.

7 Patrick A. Gaughan, *Mergers, Acquisitions, and Corporate Restructurings,* 7th edition, Hoboken, N.J., John Wiley & Sons Inc., 2018, pp. 136-137.

To go forward with the merger, the NAV, which measures the change in value resulting from the merger, must be positive. For his analysis, Gaughan excludes management-induced gains resulting from the elimination of inefficient management by installing the more capable leadership of the acquiring firm. Gaughan points out that "operating synergy can come from gains that enhance revenues or those that lower costs. Of the two, revenue enhancements can be the more difficult to achieve."[8] Consistent with this statement, while I have seen strategic premiums paid for both revenue enhancements and expense reductions, my experience suggests that the most significant premiums come from revenue enhancements.

Cost and expense reduction merger synergies usually take, in part, the form of employee layoffs—thus, are disastrous to part of the workforce. Typically, revenue enhancement synergies are job-creating; following the merger, the merged entity's total workforce will be greater than the predeal entire workforce of the acquirer and the target. Thus, most strategic premium transactions are a win-win for the workforce.

The Value Spectrum

To understand strategic buyers and the strategic premium, it is helpful to consider what I will refer to as the *value spectrum* (Exhibit 2). For this article's purpose, I have divided the value spectrum into the five sectors, where I have spent the majority of my valuation career. Typically, each sector has a unique group of potential buyers. To better understand my comments, for those

8 Ibid., p. 138.

Exhibit 2. Value Spectrum

Liquidation Value	Quasi- Going-Concern Value	"Going-Concern Basis" Stand-Alone Value	Value Including Market Participant Synergies	"Strategic Premium Price" "Investment Value" "Buyer-Specific" "Entity-Specific"
Bargain Hunter	Turnaround Specialist	Financial Buyer	Market Participant	Strategic Buyer
Lower ←		Value		→ Higher

unfamiliar with the value terms used herein, the definitions of the value terms are included in the sidebar "Value-Related Definitions of the *International Business Valuation Glossary*."

Although the main focus of this article is the strategic premium, I will comment on the five sectors to clarify concepts:

1. *Liquidation value:* Failed businesses fall into this sector. They are generally liquidated either on a forced or orderly liquidation value basis. These occur all along the business cycle but more frequently during recessions, pandemics, and major industry disruptions, when many disrupted businesses fail.

2. *Quasi-going-concern value:* It is not unusual for otherwise good businesses to experience significant financial problems, but their turnarounds are generally risky. To solve such turnaround problems, the root cause of their problems must be determined. The solutions often entail selling assets to raise cash, restructuring debt and refinancing, making changes to services and/or product lines, and improving the operations, management, and workforce changes, etc. The price paid for the turnaround enterprise opportunity should reflect the risks and a related rate of return. Some businesses go through two or three turnarounds to become successful. Others fail.

   As perhaps the most prominent example of a company where quasi-going-concern value was relevant is the trillion-dollar turnaround of Apple, which was on the brink of bankruptcy in 1997. As shown in this example, one person can often make the difference between an enterprise's success or failure: Steve Jobs was an unusually innovative, influential entrepreneur, who, in 1985, was ousted from Apple and was rehired in 1997 to lead the then-struggling company. History suggests that Jobs was perhaps the most critical factor influencing Apple's stunning turnaround.

3. *Going-concern basis stand-alone value:* This is the valuation basis under which most fair market value estimates are made. It is premised on a continuing business making a reasonable or superior rate of return. Such companies often have intangible assets. For a typical technology company, these would include patents, trade secrets, trademarks, copyrights, key employees, a trained and knowledgeable workforce, customer relationships, and general business goodwill. Valuation specialists often assume this stand-alone basis where the buyer is a financial buyer or deemed to be a market participant not benefiting from synergies. The value derived is based on a market rate of return, recognizing the business's assumed strengths, weaknesses, opportunities, and threats (SWOT).

4. *Value including market participant synergies:* The valuation basis for this sector generally is the value to a financial buyer, plus a portion of the value attributable to synergistic benefits realizable by market participants. Benefits are typically comprised of increased revenues, cost reduction through operational synergies, improved market position, and risk minimization that accompanies business combinations. All these result in an increase in expected value from the merger. These are over and above the existing combined values of the individual companies that are party to it. Of course, negative synergies and other price-lowering factors are also reflected in such transaction prices. Examples of price-lowering drivers include the potential loss of customers due to the combination, loss of key employees and intellectual property, problems caused by wage differentials between the two companies, transaction and integration costs, unexpected integration issues, etc. The number of competing market participants

Value-Related Definitions From the *International Business Valuation Glossary*

Acquisition Premium—in a merger or an acquisition, the difference between the purchase price and pre-acquisition value of the target firm. See also **Market Participant Acquisition Premium.**

Defensive Intangible Asset—an intangible asset which an entity does not intend to actively use, but rather intends to hold (lock up) the asset to prevent other parties from obtaining access to it. An example of this may be a patent.

Evidential Skepticism—the concept that **Valuation Professionals** must exercise due professional care by regularly questioning and critiquing information and data with an appropriate level of skepticism. The level of skepticism should be based on the potential for bias within the information and data (for example, multiple sources of external corroboration versus a management-generated estimate with no external corroborating support).

Fair Market Value—the (highest) price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. This term may vary based on the jurisdiction or the valuation purpose. **Valuation Professionals** must ensure they are using the most appropriate definition for the circumstances of the engagement. See also **Market Value.**

Forced Liquidation Value—liquidation value, at which the asset or assets are sold where a proper marketing period is not possible. See also **Orderly Liquidation Value.**

Going Concern Value—the value of an operating **Business Enterprise** that is expected to continue to operate into the future. The intangible elements of going concern value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place.

Intrinsic Value—the value that an investor considers, on the basis of an evaluation or available facts, to be the "true," "real," or fundamental value that will become the market value when other investors reach the same conclusion. When the term applies to options, it is the difference between the exercise price or strike price of an option and the market value of the underlying security.

Investment Value—the value of an asset to a particular owner or prospective owner for individual investment or operational objectives. In some jurisdictions, the term used is **Value to the Owner.**

Liquidation—the process of converting assets into cash and settling obligations with creditors in anticipation of the entity ceasing all activities.

Liquidation Value—the net amount that would be realized if the Business is terminated and the assets are sold piecemeal. Liquidation can be either "orderly" or "forced," which should be disclosed.

International Business Valuation Glossary continued on next page

Value-Related Definitions From the *International Business Valuation Glossary (continued)*

Market Participants—the whole body of individuals, companies, or other entities involved in actual transactions or contemplating entering into a transaction for a particular type of asset. This is a central concept of accounting standards such as IFRS and US GAAP.

Market Participant Acquisition Premium—the difference between: (1) the pro rata fair value of the subject controlling interest; and (2) its foundation. Foundation is measured with respect to the current stewardship of the enterprise. In other words, the foundation contemplates that the prerogatives of control will continue to reside with the existing controlling shareholder or group of shareholders. Market participant acquisition premium generally does not include the effect of Synergies from a particular buyer unless there are sufficient number or market participants that may benefit from similar **Synergies.**

Market Value—the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's-length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently, and without compulsion. Users of this glossary should note that market value does not reflect attributes of an asset that are of value to a specific owner or purchaser that are not available to other buyers in the market. Note—there are multiple definitions of this term. See also **Fair Market Value.** Contrast with **Synergistic Value.**

Orderly Liquidation Value—Liquidation Value at which the asset or assets are sold over a reasonable period of time to maximize proceeds received. See also **Forced Liquidation Value.**

Self-Skepticism—the concept that a **Valuation Professional** must regularly monitor their client-based presuppositions that could detract from applying skepticism as a result of comfort level or familiarity with the client, industry, or both.

Synergistic Value—the result of a combination of two or more assets or interests where the combined value is more than the sum of the separate values.

Value in (Continued) Use—the value of the assets of an operating business viewed as a pool of assets in a specific use. Value in use is determined by reference to the contribution of that asset pool to the ongoing business. Under IFRS, value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit. This term may vary based on the jurisdiction or the valuation purpose.

Valuation Professionals must ensure they are using the most appropriate definition for the circumstances of the engagement.

Value in Exchange—the worth of an asset or pool of assets if sold in the open market.

Value to the Owner—also known as **Investment Value.** *(Author's note: For some businesses, the value to its owner is greater than its fair market value. The larger value may be attributable to the additional earnings the company can realize by capitalizing on the existing owner's personal goodwill. The owner may also apply some elements of sentimental value.)*

and the availability of alternate targets will influence the portion of the synergistic value realizable by the seller.

5. *Strategic buyers pay a massive strategic premium over going-concern basis stand-alone value:* Special buyers with a uniquely synergistic or strategic opportunity usually pay the highest strategic premiums. The acquisition is so beneficial that the strategic buyer offers a very significant premium, even when not competing for the acquisition. Less frequently, a strategic premium is paid as part of a defensive strategy, a marketplace reality where the buyer is simply protecting its existing assets, revenues, and profits. Accordingly, the strategic premium price is not easily predictable or estimated. Although infrequent, there are instances where two strategic buyers will battle for an asset that they perceive as offering them significant strategic synergies. In such cases, the first bid may begin at two times (2x) "going-concern basis, stand-alone value" and quickly jump to four (4x) to 10 times (10x) that value. When paid, it is usually by a financially strong market leader for whom the payment of an extremely high price is insignificant. The valuator's typical challenge in such transactions is to opine on the fairness of the price paid.

In reviewing the transaction history of a large entity with many acquired businesses, the buy-side transactions will, for the most part, fall into two value spectrum sectors or more. Only a few, if any, will be pure "investment value—strategic premium price" transactions.

An Example of an 'Investment Value—Strategic Premium Price' Transaction

Due to the massive synergistic benefits available to the strategic buyer paying a strategic premium, even at an acquisition price greatly exceeding two times "going-concern basis stand-alone value," the buyer can still realize a higher rate of return than it usually targets. Thus, it can easily outbid financial buyers and even the majority of market participant synergistic buyers (i.e., those synergistic buyers not meeting my definition of strategic buyers).

In the simplified example I present here, the strategic buyer could be a multiproduct manufacturer and market leader in China or India, a large multinational global player, or a domestic enterprise with a uniquely synergistic opportunity. In my base case, the strategic buyer is a manufacturer of household appliances with refrigerators accounting for 10% of its $30 billion annual sales. The buyer's value enhancement strategy includes buying businesses that can be used to attain large value gains while, at the same time, minimizing risk. At a trade show, the buyer's corporate development department became aware of a patented regulator, developed and sold by Target Co., which attaches to the compressor to create a 15% energy saving. The patent had a 10-year remaining life and covered the buyer's sales territory. The corporate development department estimates that using the new technology will increase its refrigerator sales by 10%, strengthen existing dealer relationships, and create opportunities to cross-sell complimentary products and services. As a result of having industry-leading refrigerators, some retailers will switch to selling a range of strategic buyer-branded products. This will account for a 1%-to-2% increase in buyer's sales of other household appliances. I looked at two post-acquisition scenarios from the base case, where both assume constant EBITDA of 10% of sales and EBITDA capitalization multipliers by division. In the broader capital market, the post-acquisition capitalization multiplier of Target Co. would benefit from an increase, as shown in Exhibit 3. Scenario 1 assumes 1% increased sales of other household appliances, while Post-Acquisition Scenario 2 carries a 2% increase.

From the base case, we see that the immediate impact of the strategic buyer paying $50 million for Target Co., which would typically sell for $12 million, is a $38 million drop in value, from $30 billion to $29.962 billion. But this is before taking into account the unique synergistic benefits available to strategic buyer, which can be seen in the analyses in Exhibit 4.

In this acquisition, the at-risk amount was the $38 million strategic premium paid. In many strategic acquisitions, post-merger integration is of major concern. Many challenges can arise, such as leadership chaos, workforce demotivation, upset key-employee departures, synergy implementation, integration of business systems and technology, culture changes, and inadequate planning. For Target Co., integration was a minimal issue. It would be allowed to continue operating and serving its existing customer base. Thus, there were no challenges in achieving combinatorial synergies. The risk was around resourcing to scale up production to meet the needs of the strategic buyer. Under Scenarios 1 and 2, projected upside gains are in the order of $568 million to $838 million. Note that the estimated expected gains are 15 to 22 times the at-risk amount. Thus, although the strategic buyer created one or more multimillionaires, it also achieved a value increase of over $0.5 billion.

Exhibit 3. Strategic Buyer Example

Pre-Acquisition, Base Case	Strategic Buyer			Target Co.
$ Millions	Refrigerators	Household Applicance (Other)	Consolidate Household Appicances	IP Protected Productions
Sales	$3,000	$27,000	$30,000	$20
EBITDA	$300	$2,700	$3,000	$2
Capitalization multiplier			10	6
Fair Market Value, pre-acquisition			$30,000	$12
Strategic Premium Price paid by buyer				$50
Deduct: Strategic Premium Paid			$38	$38
Post-Acquisition Value, before synergies			$29,962	

Practice tip. Although Roy Thomson—a master strategic buyer with the foresight to create and sustain value-enhancing growth—made many multimillionaires among sellers through his acquisitions of newspapers and other media concerns, Thomson Reuters Corp. has become one of the world's largest information companies, with 24,400 employees and a market capitalization/value of $42 billion.

Exhibit 4. Strategic Buyer Example (continued)

Pre-Acquisition, Scenario 1	Strategic Buyer			Target Co.
$ Millions	Refrigerators	Household Applicance (Other)	Consolidate Household Appicances	IP Protected Productions
Sales	$3,300	$27,270	$30,570	$80
EBITDA	$330	$2,727	$3,057	$8
Capitalization multiplier			10	6
Fair Market Value			$30,570	$48
Strategic Premium Price paid by buyer				$50
Deduct: Effective Strategic Premium Paid			$2	$2
Post-Acquisition Value, after synergies			$30,568	
Deduct: Fair Market Value per acquisition			$30,000	
Post-Acquisition Value Increase			$568	
Pre-Acquisition, Scenario 2	**Strategic Buyer**			**Target Co.**
$ Millions	Refrigerators	Household Applicance (Other)	Consolidate Household Appicances	IP Protected Productions
Sales	$3,300	$27,540	$30,840	$80
EBITDA	$330	$2,754	$3,084	$8
Capitalization multiplier			10	6
Fair Market Value			$30,840	$48
Strategic Premium Price paid by buyer				$50
Deduct: Effective Strategic Premium Paid			$2	$2
Post-Acquisition Value, after synergies			$30,838	
Deduct: Fair Market Value per acquisition			$30,000	
Post-Acquisition Value Increase			$838	

Mergers and Acquisitions Risk

"Most M&A deals do not manage to make up for the cost of the acquisition and the destruction of shareholder value." In other words, one plus one does not even equal two, whereas three was intended. The fact that most M&A operations are doomed to destroy value has become a paradigm—and a paradox—today.[9]

Many studies suggest that between 40% and 90% of mergers and acquisitions fail to deliver the expected benefits. This applies to all three types of acquisitions: horizontal, vertical, and conglomerate. The major benefit generally sought is that the merged entity's value is greater than the sum of the entities' premerger values. In the preceding discussions, the premerger value of the target is regarded as the acquisition price. Thus, a low success rate is an indicator of risk. The reasons for the failures are many, which among others include:

1. Overestimation of the expected operating and financial synergistic benefits (I see this as the most significant problem);
2. Loss of key employees;
3. Underestimation of merger complexities;
4. Integration problems;
5. Human capital integration and managerial challenges—different management structures and styles, differing remuneration rates, selecting leaders, and essentially sidelining or demoting others, resulting in upset employees and their departures;
6. Cultural compatibility and diversity issues not being appropriately addressed;
7. Insufficient due diligence—evidential skepticism is a necessity where pertinent legal and financial information must be gathered, carefully analyzed, and confirmed;
8. Overvaluation of the target, often the result of substandard due diligence, which can be seen in an example of an Asian bank for $4 billion acquiring an established overseas bank. The transaction price included a country-specific, market-entry premium. Within a year after the transaction closing, the buyer discovered a substantial understatement of loan-loss reserves of an estimated $2 billion; and
9. Overpaying for the target can result from executives being emotionally caught up in the bidding when there are multiple bidders and, accordingly, fail to pull out of a bidding war.

Practice tip: "The evidence isn't in dispute. And as you look at M&A study after M&A study, collectively, this is not a process that creates value, and I'm afraid the disease is spreading … acquiring companies tend to overpay. By a lot. Synergy is elusive. KPMG, in a study of global acquisitions, concludes that most mergers (> 80%) fail—the merged companies do worse than their peer group."[10]

Concluding Remarks

Despite the risks and history of industry acquisition failures, the M&A success rate of strategic buyers is perhaps much higher than is commonly perceived. Strategic buyers are leading-edge market participants who know and understand the industry and the key business value drivers. They are exceptionally skilled at identifying high-impact, operating synergistic long-term value-enhancing acquisition opportunities. Their acquisitions are generally better planned and executed by remarkably experienced M&A teams

9 Fabrice Lobet and Christophe Van Gampelaere, "Success and Failure in M&A Execution—An Empirical Study," Global PMI Partners, 2021. gpmip.com/success-and-failure-in-ma-execution-an-empirical-study/.

10 Aswath Damodaran, Acquirers' Anonymous: Seven Steps to Sobriety presentation, CFA Institute Equity Research and Valuation Conference, Nov. 7, 2018.

with a broad range of skills. They perform a significant amount of due diligence. The selected targets align well with the acquirer's business and offer exceptionally high value-to-risk ratios, enabling the strategic buyer to pay significant acquisition premiums. ◆

Jim Horvath, *FCBV, ASA, ICVS, CPA, MBA, is a managing director at ValuQuest Limited in Canada.*

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May Tip From the Field

Proving Lost Profits for New Businesses

New business damages need to be measured with "reasonable certainty." Expanding on the legal definition, in economic terms, reasonable certainty can be thought of as the absence of speculation in the proffer of financial proof. In other words, the financial expert must present a damages "story," sufficiently credible and complete under the circumstances that the trier of fact will be able to tie the proffered damages calculations to the expert's reasonable assumptions and empirical support. This does not mean the court will not accept some degree of speculation, since a new business, by definition, does not have an established track record. However, along the speculation "continuum," the more relevant and reliable the evidence, the better, with the goal being to minimize the number of uncertain components inherent in any new business damages claim.

Source: Chapter 18, "Calculating Damages for Early-Stage Companies" (Neil J. Beaton, CPA/ABV/CFF, CFA, ASA, and Tyler L. Farmer, Esq.) in *The Comprehensive Guide to Economic Damages*, 6th edition, available at bvresources.com/products/the-comprehensive-guide-to-economic-damages-sixth-edition.

Fair Price for Delaware Fiduciary Actions Can Exceed Appraisal Fair Value

By Gilbert E. Matthews, Sutter Securities, Inc. (San Francisco, Calif., USA), and Matthew L. Miller, Esq., Abrams & Bayliss LLP (Wilmington, Del., USA)

Can fiduciaries of Delaware corporations breach their duties and face damages for a merger that provides stockholders with the equivalent of fair value in a judicial appraisal? The answer, which may surprise some, is yes. On March 1, 2021, the Delaware Court of Chancery issued an opinion, *In re Columbia Pipeline Group, Inc. Merger Litigation* (the "2021 Decision")[1] that expressly stated that breaches of fiduciary duty can lead to damages that exceed appraisal fair value.

Background

It has long been accepted that Delaware courts use the same valuation methodologies to determine fair value in a judicial appraisal and fair price in a fiduciary duty action.[2] There is no real debate that, "in general, the techniques used to determine the fairness of price in a non-appraisal stockholder's suit are the same as those used in appraisal proceedings."[3] However, the precise relationship between fair price in a fiduciary duty action and fair value in a related appraisal action is often unclear.

"The element of fair price … relates closely to the determination of fair value under the Delaware appraisal statute."[4] The similarities between fair price and fair value have led some to equate them, subject to the caveat that: (1) fair price is part of a standard of review based on a *range* of potentially fair prices, while (2) appraisal fair value is a remedial calculation that requires the court to determine value to the nearest cent.[5] This assumption is debatable, as fair price arguably may take into account stockholder-level discounts that would be improper in an appraisal proceeding.[6] In any event, precedent demonstrates that the precise relationship between appraisal fair value and the measure of damages in a related fiduciary duty action depends on the facts and circumstances of each case.

The fact that appraisal fair value is greater than deal price does not mean that a breach of fiduciary duty occurred. In the well-known *Technicolor* matter, the Delaware Supreme Court determined that appraisal fair value was $28.41 per share, even though it previously had affirmed the Court of Chancery's ruling in a fiduciary duty case that the $23 per share transaction price was entirely fair.[7] In a 2014 summary judgment opinion, the Court of Chancery held that defendants potentially could demonstrate that a merger was entirely fair, even though a prior appraisal decision had concluded that fair value was more than twice the merger price.[8]

1 2021 WL 772562 (Del. Ch. Mar. 1, 2021).

2 Lawrence A. Hamermesh and Michael L. Wachter, "Rationalizing Appraisal Standards in Compulsory Buyouts," 50 *B.C. L. Rev*. 1021, 1030 (2009), citing *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 940 (Del. 1985).

3 *Gesoff v. IIC Industries, Inc*., 902 A.2d 1130, 1153, n.127 (Del. Ch. 2006).

4 *In re Sunbelt Beverage Corp. S'holder Litig.*, 2010 WL 26539, at *5 (Del. Ch. Jan. 5, 2010).

5 *E.g.*, *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 461, 466 (Del. Ch. 2011); Hamermesh at 1030.

6 *E.g.*, *Basho Techs. Holdco B, LLC v. Georgetown Basho Invs., LLC*, 2018 WL 3326693, at *44-45 (Del. Ch. July 6, 2018); *Union Illinois v. Korte*, 2001 WL 1526303, at *7 (Del. Ch. Nov. 28, 2001).

7 *Compare Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1176-77 (Del. 1995), *with Cede & Co. v. Technicolor, Inc.*, 884 A.2d 26, 41 (Del. 2005). Notably, the fiduciary duty decision relied on prior management's business plan and the subsequent appraisal relied on new management's business plan.

8 *In re Orchard Enters., Inc. S'holder Litig.*, 88 A.3d 1, 30 (Del. Ch. 2014).

Despite the high-profile *Technicolor* exception, Delaware courts often find that mergers at less than appraisal value are unfair for fiduciary duty purposes and base damages on the equivalent of appraisal fair value.[9] Even if the merger price arguably falls within the low end of the fair price range, the Court of Chancery will not hesitate to award stockholders a "fairer price" if the record shows that conflicted fiduciaries structured the transaction,[10] which may be based on appraisal fair value.[11]

But what about a merger that provides stockholders with the equivalent of appraisal fair value? Can fiduciaries face liability and damages in this scenario? The answer is yes.

Delaware courts apply the principle that, "[o]nce a breach of duty is established, uncertainties in awarding damages are generally resolved against the wrongdoer."[12] Some jurisdictions refer to this principle as the "wrongdoer rule."[13] Moreover, "Delaware law dictates that the scope of recovery for a breach of the duty of loyalty is not to be determined narrowly."[14]

The 2021 Decision

Delaware courts are almost never required to rely on the differences between fair price and fair value in resolving related fiduciary duty and appraisal actions, since they routinely coordinate these actions for discovery and trial purposes. "The Delaware Supreme Court has instructed that when a merger gives rise to both a plenary action for breach of fiduciary duty and a statutory appraisal proceeding, the court should rule on the plenary claims first, because a finding of liability and the resultant remedy could moot the appraisal proceeding."[15] Accordingly, a ruling in the fiduciary duty action typically accompanies or precedes the fair value determination in the related appraisal.[16] Because appraisal petitioners are also members of the putative class in the related fiduciary duty action, the most logical response for appraisal petitioners is to accept the damages ruling in the fiduciary duty case and take advantage of whatever effect the wrongdoer rule had in increasing damages.[17]

Vice Chancellor J. Travis Laster's opinion in the 2021 Decision is a notable exception: he denies a motion to dismiss breach of fiduciary duty claims based on the principle that fair price for fiduciary duty purposes may exceed appraisal fair value. Due to the unusual procedural posture of the litigation, V.C. Laster issued the 2021 Decision 18 months after his final ruling in the related appraisal proceeding.[18]

In the 2021 Decision, V.C. Laster distinguishes between appraisal fair value, which is based on the going-concern value of the company as a stand-alone entity, and fair price in a fiduciary

9 *E.g.*, *Gesoff* at 1167; *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *33 (Del. Ch. Aug. 18, 2006); *In re Emerging Commc'ns, Inc. S'holders Litig.*, 2004 WL 1305745, at *43 (Del. Ch. May 3, 2004).

10 *E.g.*, *Reis* at 467; *ACP Master, Ltd. v. Sprint Corp.*, 2017 WL 3421142, at *19 (Del. Ch. July 21, 2017), *aff'd*, 184 A.3d 1291 (Del. 2018); *Basho* at *37.

11 *Reis* at 468.

12 *In re Dole Food Co., Inc. S'holder Litig.*, 2015 WL 5052214, at *44 (Del. Ch. Aug. 27, 2015).

13 *E.g.*, *Great Am. Opportunities, Inc. v. Cherrydale Fundraising, LLC*, 2010 WL 338219, at *23 n.270 (Del. Ch. Jan. 29, 2010) (citing decisions applying wrongdoer rule).

14 *Dole* at *44.

15 *Dole* at *25. Following the issuance of the fiduciary duty opinion in *Dole*, the Dole appraisal petitioners entered into a confidential settlement with Dole to resolve their appraisal claims.

16 *But see Orchard* at 7; *Nebel v. Sw. Bancorp., Inc.*, 1999 WL 135259, at *7 (Del. Ch. Mar. 9, 1999).

17 *Bomarko, Inc. v. Int'l Telecharge, Inc.*, 794 A.2d 1161, 1164 (Del. Ch. 1999, revised Nov. 16, 1999) (awarding damages in fiduciary duty action and declining to make appraisal fair value determination, "as it is unnecessary to do so"), *aff'd*, 766 A.2d 437 (Del. 2000).

18 *In re Appraisal of Columbia Pipeline Grp., Inc.*, 2019 WL 3778370 (Del. Ch. Aug. 12, 2019) (the "Appraisal Decision").

duty case, which considers whether breaches of fiduciary duty prevented the corporation from negotiating a better price.

> [T]he Appraisal Decision addressed a narrow question: the fair value of the Company as a standalone entity operating as a going concern. The Appraisal Decision held that the sale process was sufficiently reliable that the deal price provided a sound indication of the Company's standalone value. The Appraisal Decision did not determine whether [CEO] Skaggs and [CFO] Smith breached their fiduciary duties, nor did it address the claim that the Company could have obtained a higher deal price from TransCanada or from a competing bidder if Skaggs and Smith had not acted as they did.[19]

The 2021 Decision illustrates that, under current Delaware law, fair price in a fiduciary action may be less than, equal to, or higher than appraisal fair value.

Background of Columbia Merger

Prior to 2015, Columbia was a wholly-owned subsidiary of NiSource Inc., a publicly traded utility company. Robert Skaggs Jr. was the CEO of NiSource, and Stephen Smith was its CFO. Both had informed NiSource's board of their intent to retire in 2016. In December 2014, Skaggs and Smith both left NiSource and took the same positions at the subsidiary, which was spun off in an IPO in July 2015.[20] Each had a change-in-control agreement (golden parachute) that paid out triple the sum of his base salary and target annual bonus if he retired after a sale of Columbia before July 1, 2018, or double after that date.[21]

Columbia's management engaged Lazard Frères to examine strategic alternatives. Lazard's presentation identified several possible acquirers, including TransCanada, Dominion Energy, Berkshire Hathaway Energy, NextEra Energy, and Spectra Energy.[22] Skaggs and Smith rebuffed Spectra's expression of interest, allegedly because they believed Spectra wanted a stock deal and they wanted cash for their shares. The four other firms each expressed an interest in a cash transaction.

> On November 9, [2015,] Columbia and TransCanada entered into an NDA [non-disclosure agreement]. Over the next week, Columbia entered into additional NDAs with Dominion, NextEra, and Berkshire Hathaway Energy, and the NDA counterparties began conducting due diligence.
>
> Each NDA contained a standstill provision that prohibited the counterparty from making any offer to buy Columbia securities without the Board's prior written invitation. Most of the standstills lasted eighteen months. Each contained a feature colloquially known as a "don't-ask-don't-waive" provision (a "DADW"), which prohibited the counterparty from "making a request to amend or waive" the standstill or the NDA's confidentiality restrictions.[23]
>
> None of the prospective buyers proposed a price satisfactory to Columbia. On November 25, the Board decided to terminate the merger discussions and proceed with the equity offering, which was completed a week later. The potential acquirers were instructed to destroy the confidential information received under their NDAs.[24]

In mid-December 2015, François Poirier, TransCanada's senior vice president for strategy and corporate development, called Smith (in violation of the DADW) to reiterate its interest in a

19 2021 Decision at *2.

20 Appraisal Decision at *2-4.

21 Id. at *26.

22 Id. at *4.

23 Id. at *7.

24 Id. at *7-8.

deal. They scheduled a meeting for January 7. Smith involved Skaggs and Goldman Sachs, but no one told the board that Smith's talks with TransCanada had resumed.[25] Smith told Poirier that TransCanada was unlikely to face competition from major strategic players, telling him in substance that the company had eliminated the competition.[26]

> On January 25, 2016, TransCanada expressed interest in a transaction in the range of $25 to $28 per share. ... The Board had not waived the DADW standstill, nor had the Board invited TransCanada to make an offer. The offer breached the standstill.[27]

The board ignored TransCanada's breach of the DADW and granted TransCanada exclusivity through March 8. During the exclusivity period, Columbia could not accept or facilitate an acquisition proposal from anyone else except in limited circumstances.[28] The board had instructed Skaggs and Smith on March 4 to waive the DADW standstill provisions in the NDAs with Dominion, NextEra, and Berkshire, but they disregarded that directive until March 12.[29]

On March 9, TransCanada made a $26 per share offer, 90% in cash and 10% in stock. On March 14, TransCanada lowered its bid to $25.50 with a three-day deadline for Columbia to accept it. Columbia accepted it. The merger agreement provided for a breakup fee that would add $0.87 per share to a competitive bidder's cost, and it gave TransCanada the right to match any competitive bid.[30]

After the merger closed, litigation ensued.

25 2021 Decision at *6.

26 Id. at *7.

27 Id.

28 Id.

29 Id. at *42.

30 Id. at *9-10.

Unusual Procedural Posture

Immediately after the merger was announced, traditional stockholder plaintiffs filed a fiduciary duty action attacking the proposed merger. On March 7, 2017, V.C. Laster granted the defendants' motion to dismiss.[31]

Several stockholders, primarily merger arbitrageurs, filed a petition for judicial appraisal. After trial, V.C. Laster ruled that fair value under the appraisal statute was equal to the $25.50 merger price.[32]

While the appraisal case was pending, stockholders filed federal securities claims in the Southern District of New York. On September 26, 2019, the district judge granted the defendants' motion to dismiss.[33]

While the appraisal was pending, certain Columbia stockholders that had not demanded appraisal filed a putative class action claiming that breaches of fiduciary duty by Skaggs and Smith prevented them from receiving a fair price for their shares. In pleading their claims, these stockholders ("Plaintiffs") relied on discovery from the appraisal proceeding that had become publicly available. Plaintiffs claimed that Skaggs and Smith were motivated by a desire to sell the company to trigger their golden parachutes and that they favored TransCanada to the detriment of other interested buyers. Plaintiffs also alleged that the officers withheld certain facts from the board and that there were material omissions in the merger proxy statement.

Plaintiffs in the second fiduciary duty action sought to consolidate their case with the appraisal action. TransCanada objected, claiming that consolidation would unnecessarily delay

31 *In re Columbia Pipeline Grp., Inc.*, 2017 WL 898382 (Del. Ch. Mar. 7, 2017).

32 Appraisal Decision at *52.

33 *In re Columbia Pipeline, Inc.*, 405 F. Supp. 3d 494 (S.D.N.Y. 2019).

the appraisal case, which was nearing trial. V.C. Laster agreed with TransCanada and denied Plaintiffs' motion to consolidate.

Distinguishing Appraisal Valuations From Damages in Fiduciary Duty Actions

After the appraisal case concluded, the defendants in the second fiduciary duty action moved to dismiss Plaintiffs' claims. The defendants argued that the fair value determination in the Appraisal Decision should be dispositive of fair price in the fiduciary duty action. On March 1, 2021, V.C. Laster, who had presided in the appraisal, denied the defendants' motion to dismiss. He explained that none of the petitioners from the appraisal action were parties to the class action and that Plaintiffs were not parties to the appraisal action, federal securities action, or original class action.[34] He further explained that the appraisal case and second fiduciary duty claim involved different inquiries:[35]

> [T]he Appraisal Decision focused exclusively on whether the sale process "was sufficiently reliable to make the deal price a persuasive indicator of fair value." The Appraisal Decision did not examine whether the sale process resulted in "the best value reasonably available for the stockholders." As a result, the Appraisal Decision did not evaluate the possibility of a fiduciary breach based on the prospects for a better price from TransCanada or a higher bid from a third party.[36]

V.C. Laster emphasized the same point later in the 2021 Decision:

> Because of the limitations of an appraisal proceeding, the court does not evaluate the possibility of a higher negotiated price or the potential for an offer from an alternative bidder, except to the extent that those factors touch on the relationship between the deal price and standalone value. In this instance, the Appraisal Decision did not evaluate whether the sale process resulted in the best value reasonably available to stockholders, and the Appraisal Decision did not determine whether management's conduct undermined the Board's ability to obtain a higher price from TransCanada or a different bidder.[37]

V.C. Laster noted the Delaware Supreme Court's instruction that "[t]he issue in an appraisal is not whether a negotiator has extracted the highest possible bid. Rather, the key inquiry is whether the dissenters got fair value and were not exploited."[38] He further explained:

> Under the appraisal statute, fair value means the value of the company as a standalone entity. To determine the company's fair value, the court values the corporation as a going concern based on its operative reality at the point in time when the merger closed. The court looks to the company's standalone value as a going concern because "[t]he underlying assumption in an appraisal valuation is that the dissenting shareholders would be willing to maintain their investment position had the merger not occurred."[39]

Importantly, V.C. Laster held that fair price for breach of fiduciary duty could be greater than appraisal fair value because damages from a breach could include the incremental amount that a buyer would have offered but for the improper conduct of the CEO and CFO.

> [T]he defendants ... argue that the Company's stockholders could not have suffered damages if they received an amount that this court found

34 2021 Decision at *27-29.

35 Id. at *2.

36 Id. at *33, quoting *Paramount Comm'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 46 (Del. 1994).

37 Id. at *46.

38 *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, 177 A.3d 1, 33 (Del. 2017).

39 2021 Decision at *44, quoting *M.P.M. Enters., Inc. v. Gilbert*, 731 A.2d 790, 795 (Del. 1999).

> to be the standalone value of the Company. That damages remedy is not what the plaintiffs are seeking. They contend that stockholders lost out on the difference between the $25.50 that they received and the higher amount that TransCanada or another bidder would have paid.[40]

Breaches of Fiduciary Duty

In the 2021 Decision, V.C. Laster held that Plaintiffs adequately had pled claims for breach of fiduciary duty. He observed that favoritism toward TransCanada allegedly began in mid-December 2015 when Poirier, in violation of the DADW provision, called Smith to reiterate TransCanada's interest in acquiring Columbia. Prior to the January 7 meeting, Smith emailed Poirier 190 pages of confidential information, which included "critical information that enabled TransCanada to assess the Company's value and make a bid."[41]

> It is reasonable to infer that the January 7 Meeting undercut the Company's ability to negotiate the best value reasonably available from TransCanada. The Board had not authorized Smith to meet with TransCanada, much less to give TransCanada non-public information plus advice on how to avoid a competitive sale process. Skaggs and Smith never told the Board the full story about the January 7 Meeting or Smith's unauthorized disclosures. Although Skaggs generally was forthcoming with the Board, in this instance he told the directors that TransCanada had reached out to Smith, without mentioning that Smith met with Poirier and without reporting Smith's unauthorized disclosures.[42]

V.C. Laster concluded: "The factual allegations of the Complaint support a reasonable inference that Skaggs and Smith tilted the sale process in favor of TransCanada and against the other bidders so that they could obtain a cash deal that would enable them to retire with their change-in-control benefits" and that "it falls outside the range of reasonableness to tilt the playing field against one bidder and in favor of another, not in a reasoned effort to maximize advantage for the stockholders, but because the fiduciaries have personal reasons to prefer the favored bidder."[43] He held that plaintiffs had pled facts sufficient to state a claim for breach of duty by supporting a reasonable inference that the merger and the process that led to it fell outside the range of reasonableness.[44]

The 2021 Decision also noted that the Appraisal Decision had identified three material misstatements and omissions in the merger proxy statement (the Proxy).[45] The first disclosure issue was that the Proxy statement created the misleading impression that the other prospective bidders were not bound by standstills during the pre-signing period. The Appraisal Decision stated:

> The Proxy disclosed that Columbia had entered into NDAs in November 2015 with Parties B, C, and D, but the Proxy did not disclose that the NDAs contained standstills, much less DADWs. The Proxy then disclosed misleadingly that "[u]nlike TransCanada, none of Party B, Party C or Party D sought to re-engage in discussions with [Columbia] after discussions were terminated in November 2015." The Proxy failed to provide the additional disclosure that all four parties were subject to standstills with DADWs, that TransCanada breached its standstill, and that Columbia opted to ignore TransCanada's breach.[46]

The second disclosure issue was the Proxy's failure to disclose Skaggs' and Smith's plans to retire in 2016 because "a reasonable stockholder would have regarded their plans as material."[47]

40 Id. at *56.

41 Id. at *41.

42 Id.

43 Id.

44 Id. at *51.

45 Appraisal Decision at *36.

46 Id., quoting Proxy.

47 Id. at *36.

The third and most material disclosure issue was the incomplete disclosure about the January 7 meeting, where the Proxy failed to mention that Smith had invited a bid from TransCanada and had told Poirier that it did not face competition.[48]

The vice chancellor concluded that "these findings and the evidence that supported them give rise to a reasonable pleading-stage inference that the stockholder vote on the Merger was not fully informed."[49]

Relevant Prior Decisions

The holding in the 2021 Decision that fiduciaries conceivably can face liability for approving a merger that provided stockholders with the equivalent of appraisal fair value may surprise some. However, numerous opinions have recognized that stringent remedies are available for breaches of the duty of loyalty. For more than 30 years, *Revlon* has required corporate fiduciaries to take reasonable steps to obtain "the best price for the stockholders at a sale of the company."[50] The 2021 Decision applied these straightforward principles.

Previous opinions by V.C. Laster have emphasized that damages in fiduciary duty actions should be based on the value stockholders likely would have received if "faithful fiduciaries" had negotiated the challenged transaction, without any reference to appraisal fair value. For example, in a 2012 opinion, V.C. Laster found certain fiduciaries jointly and severally liable for damages based on the circumstances that likely would have existed if the corporate officers had been "faithful fiduciaries."[51] His 2015 fiduciary duty opinion in *Dole* is particularly instructive. He wrote:

> [Dole's Chairman and CEO] Murdock and [President and COO] Carter's conduct throughout the Committee process, as well as their credibility problems at trial, demonstrated that their actions were not innocent or inadvertent, but rather intentional and in bad faith.
>
> Under these circumstances, assuming for the sake of argument that the $13.50 [transaction] price still fell within a range of fairness, the stockholders are not limited to a fair price. They are entitled to a fairer price designed to eliminate the ability of the defendants to profit from their breaches of the duty of loyalty.[52]

V.C. Laster cited three Supreme Court decisions in support of his position.[53] The seminal *Weinberger* opinion said:

> The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved. Under such circumstances, the Chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages.[54]

Technicolor stated that "the measure of any recoverable loss … under an entire fairness standard of review is not necessarily limited to the difference between the price offered and the 'true' value as determined under appraisal proceedings."[55] In *Bomarko,* the Supreme Court ruled:

48 Id.

49 2021 Decision at *33. The defendants in this case have requested certification of an interlocutory appeal to the Supreme Court.

50 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

51 *Dweck v. Nasser*, 2012 WL 161590, at *17 (Del. Ch. Jan. 18, 2012).

52 *Dole* at *6.

53 Id. at *44.

54 *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983).

55 *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 371 (Del. 1993).

> In an appraisal action, a court must determine the fair value of the stockholders' shares at the time of the merger. The question faced by the trial court in the instant action was determining what ITI's stockholders' "shares would have been worth at the time of the Merger if [ITI's CEO] Haan had not breached his fiduciary duties." … Haan's breach of his duty of loyalty to ITI, in all likelihood, influenced the fairness of the merger transaction and concomitantly the price ITI's stockholders received for their shares. *The Court of Chancery has greater discretion when fashioning an award of damages in an action for a breach of the duty of loyalty than it would when assessing fair value in an appraisal action* [emphasis added].[56]

In the *Dole* opinion, V.C. Laster calculated damages based on his determination of what faithful fiduciaries likely would have achieved in the challenged merger.[57]

In a 2017 opinion, he explained that the inquiry into what "faithful fiduciaries" could have achieved must take into account the strength of the corporation's bargaining position:

> [W]hat was beneficial to [the controlling stockholder] and what was fair to the Company and its common stockholders are two different things. The latter is measured by what faithful fiduciaries could have achieved in light of [the controlling stockholder's] relatively weak contractual position.[58]

He further explained this approach in a 2019 opinion:

> When seeking post-closing damages for a breach of fiduciary duty in a sale process, the measure of damages logically depends on what the plaintiffs contend would have happened absent the breach. If the plaintiffs prove that the defendants could have sold the corporation to the same or to a different acquirer for a higher price, then the measure of damages should be based on the lost transaction price.[59]

There is nothing novel about this approach to calculating damages. In a 1996 opinion, then-Vice Chancellor Jack Jacobs recognized his "discretion to craft from the 'panoply of equitable remedies' a damage award that approximates a price the board would have approved absent a breach of duty."[60]

Conclusion

The 2021 Decision highlights the principle that fair price in a fiduciary duty action can exceed appraisal fair value. The wrongdoer rule is now well-established in Delaware law, and the Supreme Court has recognized that the Court of Chancery has greater discretion when making a damages award for breach of fiduciary duty than in assessing fair value in an appraisal.[61] The 2021 Decision confirms that, if breaches of fiduciary duty caused the buyer to pay less than it otherwise would have, stockholders should receive the higher price that the Court of Chancery determines the buyer would have paid, even if the price the buyer paid was equal to or greater than going-concern value. ◆

Gilbert E. Matthews, *CFA, is chairman emeritus and a senior managing director of Sutter Securities, Inc. (San Francisco).* ***Matthew L. Miller,*** *Esq., is an associate at Abrams & Bayliss LLP (Wilmington, Del.).*

56 *Bomarko,* 766 A.2d 437, 440-41.

57 *Dole* at *46.

58 *Frederick Hsu Living Tr. v. ODN Hldg. Corp.*, 2017 WL 1437308 (Del. Ch. Apr. 14, 2017) at *35.

59 *In re PLX Tech. Inc. S'holders Litig.*, 2018 WL 5018535, at *51 (Del. Ch. Oct. 16, 2018), *aff'd*, 211 A.3d 137 (Del. 2019).

60 *Ryan v. Tad's Enters., Inc.*, 709 A.2d 682, 699 (Del. Ch. 1996), *aff'd*, 693 A.2d 1082 (Del. 1997).

61 *Americas Mining Corp. v. Theriault*, 51 A.3d 1213, 1252 (Del. 2012).

Letter to the Editor: The Use of the Arithmetic Mean to Average Multiples

I read with a great deal of interest Gil Matthews' article titled "Do Not Use the Arithmetic Mean to Average Multiples" in the April 2021 issue of *Business Valuation Update* (Vol. 27, No. 4). I have long regarded Mr. Matthews as one of the industrial-strength thinkers in our profession, and so I always look forward to hearing what he has to say on any valuation topic. But, in this instance, even though I agree with the article's title, I must respectfully disagree with the advice he gives and the conclusions he reached in his article, specifically his comment that the "harmonic mean should be used as the appropriate measure of central tendency" for a sample of market multiples.

None of the ratio measures of central tendency, be it the arithmetic, harmonic, or weighted harmonic mean or even the median, perform well outside the interquartile range (25th to 75th percentiles) of the distribution of multiples. So, unless the subject company has SDE, revenue, EBIT, or EBITDA close to the midpoint (40th to 60th percentiles) of the sample distribution, the resulting value calculation will be less reliable than it could be. I will demonstrate this further along in this letter, but first I want to explain when the arithmetic mean, harmonic mean, and weighted harmonic mean are appropriate to use in general terms, and, second, I want to respond to the comments Mr. Matthews made about regression analysis.

There are situations where the harmonic mean is a necessary choice as a measure of central tendency. For example, if I were to spend $1,000 a month for five months buying shares of a particular stock when the price was $4, $5, $8, $10, and $20 per share, the average cost of my 725 dollar-averaged shares would be $6.90 computed using the harmonic mean. On the other hand, if I were to buy 145 shares a month for five months at the same price per share given above, I would wind up with 725 shares with a dollar-averaged cost of $9.40, calculated using the arithmetic mean. From this example, we can derive a general rule—for cost per share, when cost is given and is a constant, we use the harmonic mean. When the number of shares purchased is given as a constant, we use the arithmetic mean.

This same reasoning applies to rate, time, and distance problems. For example, if three automobiles that drive at 10, 20, and 30 mph, respectively, with each traveling a distance of 30 miles, the average rate of speed is 16.4 mph, calculated using the harmonic mean. On the other hand, if the same three automobiles travel for eight hours each, the average speed is 20 mph, calculated using the arithmetic mean. The general rule applies here as well—when the ratio is mph, if miles (distance) is given as a constant, then the harmonic mean is the correct measure of central tendency. However, if time (hours) is given as a constant, the arithmetic mean is the proper choice. It all depends on whether the constant factor is in the numerator or denominator of the ratio.

However, in the situation where Automobile A travels 50 miles at 40 mph, Automobile B travels 60 miles at 50 mph, and Automobile C travels 40 miles at 60 mph, the average rate of speed is 48.13 mph, computed using the weighted harmonic mean. This is so because neither the numerator nor the denominator of the ratio consists of a constant. The weighted harmonic mean is the "ratio of the averages" as opposed to the "average of the ratios" calculated using the arithmetic mean. Thus, for valuation multiples, since neither price nor SDE is ever a constant in a distribution of market transactions, the proper average multiple is computed using the weighted harmonic mean—but only if your subject company is average or close to the median in size as measured by SDE will you get decent results with this procedure.

Mr. Matthews takes exception to the weighted harmonic mean, claiming that a major infirmity of the procedure is the requirement of "a subjective judgment as to what factor to use for weighting the multiples." But this just is not so—the weights are inherent in the procedure and are not chosen by the user. As stated above, the short-cut procedure for the weighted harmonic mean is to take the ratio of the averages, i.e., dividing the average selling price by the average cash-flow metric of choice, e.g., SDE. The long-form procedure is to first weight each observation by its proportionate amount of selling price and then sum these weights, which, of course, will always give you a total of one. The second step is to divide each observation's weight by its P/SDE ratio and then sum these quotients. Finally, divide the sum of the weights by the sum of the weighted P/SDE ratios—the result will be the weighted harmonic mean. In the case of the three automobiles presented above, the weights are the proportions of miles driven, which is then divided by each car's mph ratio. Summing both columns and then dividing 1 by 0.0208, we derive 48.13 mph. And, yes, weighting is a factor in deriving both the arithmetic mean and the weighted harmonic mean—the latter weighted by the size of the ratio and the former by the size of the selling price. But so what—I am not convinced that this fact of the universe is a problem.

However, if you do see weighting as a problem, then you can turn to the median, which, despite Mr. Matthews' assertion, is no more affected by small samples than any other measure of central tendency. And the fact that the median "does not give any consideration to skewness in the data" is a feature, not a bug.

Lastly, let us turn our attention to regression analysis. Mr. Matthews asserts that "regression analysis is not used unless there is a large number of observations." First, what does he mean by "large," and second why doesn't this caution also apply to any other method of determining a selling price using the direct market data method? If the sample size is large enough for the harmonic mean, then it ought to be large enough for a regression model.

Mr. Matthews next asserts that a regression model "brings in an element of subjective judgment" as to which independent variables to include in the model. Leaving aside the question of whether or not the choice of model inputs is subjective, the use of multiple regression analysis is not required when developing an expected selling price within the direct market data method. Simple linear regression analysis with selling price as the dependent variable and some cash-flow metric as the independent variable is sufficient to produce excellent results.

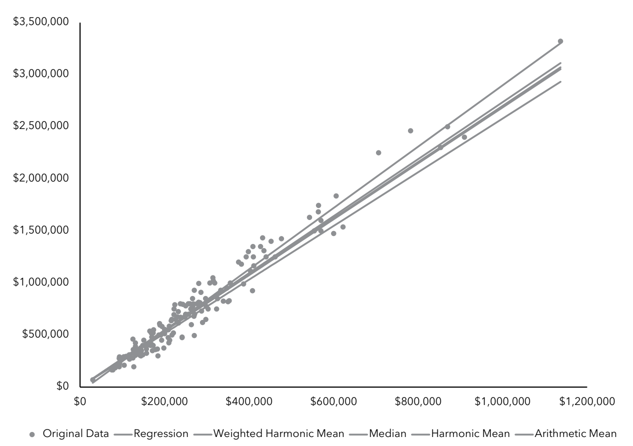
Notwithstanding everything said above, let us do a direct comparison of all five models and see which model(s) has the better performance metrics. I selected NAICS category 561730, Lawn Maintenance, chose SDE as my cash-flow metric and began the exercise with 182 data points. For each measure of central tendency—the arithmetic mean, the median, the harmonic mean, and the weighted harmonic mean—I first calculated the valuation multiple, then estimated the selling price, then calculated the root mean squared error based on the difference between actual selling price and estimated selling price, then standardized those differences and finally removed all standardized observations greater than 2.5 standard deviations. I followed the same essential procedures for the regression model, removing all standardized residuals greater than 2.5. The results can be seen in Exhibit 1.

This model output comparison schedule, along with Exhibit 2, indicates that, if a subject company has average or median cash flow, then there is practically no difference among all five models as to estimated selling price. As the original data set was very homogeneous to begin with, even within the interquartile range, there is less than a 10% difference between the regression model and any of the other four models. However, when moving

Exhibit 1. Comparison of Model Outputs

		Predicted Price					
	SDE	Arithmetic Mean	Median	Harmonic Mean	Weighted Harmonic Mean	Simple Linear Regression	Regression Multiple *
Subject–5%	93,171	250,245	251,682	240,314	254,981	227,146	2.44
Subject–10%	117,000	314,247	316,051	301,776	320,194	297,347	2.54
Subject–25%	157,000	421,682	424,103	404,947	429,661	415,188	2.64
Subject–50%	232,788	625,239	628,828	600,426	637,070	638,460	2.74
Subject–75%	332,802	893,864	898,995	858,390	910,778	933,103	2.80
Subject–90%	476,564	1,279,990	1,287,339	1,229,193	1,304,211	1,356,628	2.85
Subject–95%	600,000	1,611,523	1,620,775	1,547,570	1,642,018	1,720,273	2.87
RMSE		111,561	110,525	129,000	108,984	102,969	
CoV		15.2%	14.9%	18.2%	14.5%	13.6%	
Improvement>mean			0.9%	-15.6%	2.3%	7.7%	
Multiple		2.69	2.70	2.58	2.74	*	
Outliers		23	23	21	23	25	
Final count		159	159	161	159	157	

Exhibit 2. Price vs. SDE



outside the interquartile range, the four models all tend to overvalue at the lower end and undervalue at the high end. Since the interquartile range represents 50% of the observations, this means that the other 50% of the observations are being incorrectly valued if one uses any of the four measures of central tendency to derive a valuation metric. For data sets that are not so homogeneous (coefficients of variation of 25% to 30%), the degree of incorrectness accelerates, suggesting that valuation analysts should proceed with caution if their subject company is outside the interquartile range of their chosen cash-flow metric.

The schedule also shows, as indicated by the smallest RMSE, the lowest coefficient of variation, and the best performance against the arithmetic mean, that simple linear regression should be the estimating procedure of choice—and certainly not the harmonic mean.

In conclusion, I would recommend that, after downloading a database of market transactions, the valuation analyst curate it by removing obvious misclassifications and outliers. Next, see where the subject company lies on the distribution by comparing its cash-flow position on a percentile basis with that of the market transactions. Finally, select a procedure accordingly, or better, run all five procedures as outlined above and choose what one considers the best fit for the subject company.

Sincerely,

Mark G. Filler, CPA/ABV, CBA, CVA, AM
Filler & Associates PA,
Portland, Maine ◆

Personal v. Enterprise Goodwill in Florida Divorce Cases: What the Appellate Courts Say

By Jimmy Stewart, Baker Tilly (Tampa, Fla., USA)

This article is based on my analysis of marital dissolution case law from the Florida Supreme Court and the five District Courts of Appeal (DCA) of Florida[1] that relates to the valuation of personal and enterprise goodwill in the state of Florida.[2]

Introduction and history. In states where personal goodwill is not transferable, such as in Florida, it is important to understand the case law that outlines how courts have ruled on the issue of personal versus enterprise goodwill. Failure to abide by these guidelines will likely result in an adverse outcome.

There are several definitions of goodwill. In the state of Florida, goodwill is defined by the Florida Supreme Court case *Swann v. Mitchell (1983).*[3] In *Swann v. Mitchell,* goodwill was defined as "the advantage or benefit the business has beyond the mere value of its property and capital." This defines total goodwill, which is comprised of personal goodwill and enterprise goodwill.

The method for *quantification* of total goodwill in Florida was provided in the landmark case *Thompson v. Thompson (1991),*[4] which stated that "fair market value … of the business … [in] excess over assets would represent goodwill."

The Florida Supreme Court first established the current legal standards for personal versus enterprise goodwill in Florida in *Thompson*. In *Thompson*, the court: (i) defined personal goodwill versus enterprise goodwill; (ii) determined that personal goodwill was not subject to equitable distribution in a dissolution of marriage but that enterprise goodwill was subject to equitable distribution; and (iii) established a concept that total goodwill was to be measured as the fair market value of the company as determined by the valuation expert under the market and/or income approaches less the value arrived at utilizing the asset approach.[5]

The theory behind the concept of goodwill in Florida outlined in *Thompson* is that the value of the business as determined under the asset approach represents a minimum transferable asset value, and any value above that amount is due to either the goodwill of the individual (personal goodwill), which is nontransferable, or the goodwill of the business (enterprise goodwill), which is transferable.

Because personal goodwill is nontransferable in Florida for purposes of equitable distribution, the only goodwill that is subject to equitable distribution per *Thompson* is goodwill that "exist[s] separate and apart from the reputation or continued presence of the marital litigant" (i.e., enterprise goodwill).

1 The Florida Supreme Court is the highest court in Florida. The Florida Supreme Court and the five District Courts of Appeal comprise the appellate court system in Florida.

2 The trial court records are not available online. Therefore, all information regarding trial court facts and decisions are based on the appellate court records.

3 *Swann v. Mitchell*, 435 So. 2d 797 (Florida Supreme Court).

4 *Thompson v. Thompson*, 576 So. 2d 267 (Florida Supreme Court).

5 The court in *Thompson* used terms for business valuation that do not conform to the exact terms that would be found in business valuation literature. The use of specific approaches such as the income, market, and asset approaches to determine goodwill is based on the *Thompson* court's descriptions, treatment by business valuation practitioners in cases that followed *Thompson*, the rejection of an industry rule of thumb as "nonsensical" in *Young* (1992—5th DCA), and my understanding of business valuation.

In the case of *Walton v. Walton* (1995—4th DCA),[6] the court recognized that a noncompete clause was an indicator of personal goodwill; this concept was later expanded in *Held v. Held* (2005—4th DCA)[7] to any agreement that either requires the continued presence of the business-owning spouse or that restricts the business-owning spouse from his or her trade after a sale, such as a nonpiracy agreement, nonsolicitation agreement, etc.

Therefore, a hypothetical sales price must assume that the business-owning spouse no longer works at the business upon the sale and that the business-owning spouse is not restricted from operating his or her trade in another business entity.

Schmidt v. Schmidt (2013—4th DCA)[8] went on to reject a valuation expert's conclusion of value of a business that was based on the assumption that the business owner spouse would have to execute a transitional agreement and a noncompete agreement because this would require the spouse's continued presence in the business after the hypothetical sale.

While the concept of personal goodwill was originally applied to cases involving professionals (doctors, attorneys, CPAs, etc.), this concept was definitively expanded to nonprofessional businesses in *Christians v. Christians* (1999—4th DCA).[9] In *Christians,* it was the husband's relationships with clients that formed the basis of his personal goodwill in his trapeze equipment business.

The market approach. Using the market approach to value a company for the purposes of marital dissolution in Florida presents its own challenges. In *Weinstock v. Weinstock* (1994—5th DCA),[10] the wife's expert valued the husband's dental practice by using a market approach, which relied on 11 comparable transactions. The court rejected the wife's expert's valuation and stated that it was "an inescapable conclusion that none of the comparables included a situation where a selling professional did not remain with the buyer … for a period of time after closing the sale." The court stated that the "comparables used cannot serve as competent evidence of value in view of the language in *Thompson"* because the use of these comparables assumed the continued presence of the husband in the business, which represents the husband's personal goodwill.

In *King v. King* (46 Fla. L. Weekly D 498),[11] the court rejected the wife's expert's valuation of the husband's personal goodwill in an insurance company the husband operated. The wife's expert calculated the husband's personal goodwill in the business by calculating the percentage of the sales price allocated to noncompete agreements for comparable transactions in DealStats. He then applied the average noncompete percentage as the percentage of the husband's personal goodwill in the insurance business. The court rejected the wife's expert's valuation because: (i) he "did not provide any specific knowledge about the particulars" of the comparable transactions; (ii) he "did not disclose whether the owners of those businesses also sold insurance … how involved the owners of those businesses had been with the companies, or anything about the day-to-day operations of those businesses"; and (iii) "many of the transactions … took place outside Florida, with some dating back almost twenty years." (A case analysis appears separately in this issue.)

As discussed above, *Walton* and *Held* established that noncompetition and other types of agreements that require the continued presence in the business represent personal goodwill. Therefore, one has to tread carefully when utilizing the market approach when personal goodwill is present.

6 *Walton v. Walton*, 657 So. 2d 1214 (4th DCA).

7 *Held v. Held*, 912 So. 2d 637 (4th DCA).

8 *Schmidt v. Schmidt*, 120 So. 3d 31 (4th DCA).

9 *Christians v. Christians*, 732 So. 2d 47 (4th DCA).

10 *Weinstock v. Weinstock*, 634 So. 2d 775 (5th DCA).

11 *King v. King*, 46 Fla. L. Weekly D 498.

Acceptable approaches and methods. While the Florida Supreme Court and the five DCAs outline the structure and some of the boundaries in calculating personal versus enterprise goodwill, there are still some ambiguities in terms of which approaches and methods for calculating goodwill the courts will accept in the future.

What *is* clear from *Thompson* is that, in order to calculate goodwill, a practitioner must value the business under the fair market value standard of value, and the *total* goodwill should be calculated as the difference between the value of the business under the income and/or market approach versus the value of the business under the asset approach.

The value of the total goodwill must then be allocated between personal and enterprise goodwill. It is generally insufficient to merely determine an amount of personal versus enterprise goodwill. The business valuation practitioner must be able to document and explain the allocation of goodwill.

In situations where the business valuation practitioner has failed to provide competent, credible evidence to support his or her opinion of personal versus enterprise goodwill, and there is ample evidence of personal goodwill, the appellate courts have generally defaulted to the position that all of the goodwill is personal in nature.

The key for the business valuation practitioner is to be able to identify the total goodwill in a business, utilize a reliable methodology to determine the amount of personal versus enterprise goodwill, and, of course, communicate his or her findings to the court with sufficient evidence.

Personal and enterprise goodwill can be calculated under three separate approaches: the bottom-up approach, the top-down approach, and the "with and without" approach. Multiple approaches may be utilized to support the final conclusion.

The bottom-up approach attempts to value the subject goodwill based on the value of individual intangibles that make up goodwill. This can be useful to determine a minimum value of personal or enterprise goodwill. The downside is that individual intangible assets may be difficult to value.

The top-down approach values the entire business, determines the amount of total goodwill, and then attempts to split the goodwill between personal and enterprise. As outlined in *Thompson,* the top-down approach must be used in Florida to calculate *total goodwill* in a business.

The multiattribute utility model (MUM), developed by David Wood, CPA/ABV, CVA, CFFA, is an example of a method that can be used with the top-down approach after total goodwill has been determined.[12] MUM can be used as a sanity check. This method provides rationality, which is lacking in some of the methodologies utilized in the Florida appellate cases regarding personal goodwill that I have reviewed. If nothing else, the utilization of MUM forces the business valuation practitioner to consider the goodwill attributes unique to the situation and provides the expert with the ability to allocate total goodwill between personal and enterprise goodwill in a nonarbitrary manner.

The with and without approach is based on the value of the business with the business-owning spouse and the value of the business without the business-owning spouse. The difference between these two values represents personal goodwill. This is generally done using the income approach to develop each value. When using this approach, the business valuation practitioner must avoid overemphasizing the effect that the business-owning spouse has on the business. For example, in *Hough v. Hough* (2001—2nd DCA),[13] the court rejected a with and without calculation because the business valuation practitioner used

12 "MUM's the Word: A Formal Method to Allocate Blue Sky Value in Divorce," by David Wood in *BVR's Guide to Personal v. Enterprise Goodwill,* 5th edition, (2012, Business Valuation Resources); bvresources.com/products/bvr-guide-to-personal-v-enterprise-goodwill-fifth-edition.

13 *Hough v. Hough*, 793 So. 2d 57 (2nd DCA).

different revenue levels *and* different capitalization rates (to reflect the increased risk due to the lost revenues) to calculate each value.

Conclusion. While some of the decisions in the Florida appellate courts conclude that goodwill is 100% personal or 100% enterprise, in most cases, there are no such absolutes. Certain attributes will indicate that at least some personal or enterprise goodwill is present. For example, a business name that is different from the business owner's name is an indication that there is likely at least a thimbleful[14] of enterprise goodwill.

In *Kovats v. Gregg-Kovats* (2008—5th DCA),[15] the court stated that it "is incumbent upon the proponent of the existence of enterprise goodwill to present evidence from which the trial judge can make such a finding." *Kovats* ruled that there is a burden on the party asserting the existence of enterprise goodwill to provide the appropriate evidence, and this emphasizes the role that the business valuation expert has in asserting any claim of enterprise goodwill in a business.

The use of any approach to calculate personal and enterprise goodwill should take into consideration all of the various attributes of personal and enterprise goodwill, and, if the information is available, it is advisable to be aware of any agreements that could have an impact on personal or enterprise goodwill, such as shareholder agreements, noncompetition agreements, stock purchase agreements, buy-sell agreements, etc. There may be clauses in these agreements that represent some level of personal or enterprise goodwill.

When calculating personal and enterprise goodwill in Florida, it is important to utilize methodologies that conform to *Thompson* and for the business valuation practitioner to provide competent, credible, and substantial evidence regarding any such valuation. There are numerous cases in the Florida appellate courts where the findings by the court could have been materially different if the proper evidence and testimony had been proffered. For example, in *Nelson v. Nelson* (2001—5th DCA),[16] where the business-owning spouse failed to argue that the business value contained personal goodwill at trial, the 5th DCA ruled: "It appears this issue has been waived." This demonstrates that failure to provide competent evidence and arguments at trial can result in an outcome that is contrary to the spirit of *Thompson*. ◆

Jimmy Stewart, *CPA/ABV/CFF, CFE, is a manager in the Tampa (Florida) office of Baker Tilly; he provides business valuation, forensic accounting, and litigation services.*

14 Justice Makar used this term in his dissenting opinion in *Kearney* (2014—1st DCA), and I have appropriated it.

15 *Kovats v. Gregg-Kovats*, 984 So. 2d 1277 (5th DCA).

16 *Nelson v. Nelson*, 795 So. 2d 977 (5th DCA).

BVU News and Trends

A monthly roundup of key developments of interest to business valuation experts.

Regulators, Standard-Setters, VPOs

ASA changes report requirement for AM candidates

More valuation professionals will now qualify for the American Society of Appraisers (ASA) business valuation discipline's Accredited Member (AM) designation. Candidates seeking the AM designation will no longer need to submit an appraisal report. This change reflects the need for advanced education by a growing number of professionals who perform valuation analysis but whose conclusions are not included in traditional appraisal reports. Johnnie White, ASA CEO, creatively describes the AM credential as similar to earning a master's degree and the ASA credential as similar to earning a doctorate degree.[1]

Credential program for value growth advisors June 7-11

A natural extension to valuing a business is advising business owners on ways to maximize that value. A training and credentialing program is available for valuation professionals who want to add this type of advisory service to their practices. The Certified Value Growth Advisor (CVGA) program is a five-day course that focuses on the fundamental best practices that drive value of any business.[2] You will also learn how to build on those drivers to develop a short-term tactical plan and long-term strategic plan for the client's business. The next CVGA program is scheduled for June 7-11 and will be in a virtual environment.

New association formed for healthcare compensation pros

The American Association of Provider Compensation Professionals (AAPCP) is a new nonprofit group whose members advise and lead healthcare organizations on provider compensation, contracting, planning, recruitment, retention, strategy, and, yes, valuation.[3] The fair market value of physician compensation and related arrangements is an area subject to increasing scrutiny amid complex regulations. The determination of FMV is handled by staffers at healthcare systems as well as external valuation experts, and both these groups are among the ranks of AAPCP members.

Business Valuation Update spoke with Alex Krouse, JD/MHA, who is legal counsel at Parkview Health and one of the key people behind the formation of the AAPCP. He told us that the organization will develop a body of knowledge, resources, best practices, and training for individuals and firms engaged in provider compensation. Plans also include providing certification and an interactive forum. They were planning their first annual conference last spring, but the pandemic derailed that event, which will be rescheduled. The agenda included topics of interest to all healthcare valuation experts, such as:

- A regulatory overview for provider compensation professionals;
- Nuts and bolts of FMV and commercial reasonableness;
- Compensation surveys and updates; and
- FMV for "thorny" deal scenarios.

The fledgling AAPCP looks like it's off to a great start!

Methods and Approaches

Mercer and Harms tie BV together into one neat bundle

Business valuation is like one huge jigsaw puzzle, and practitioners can often find themselves focusing too much on the individual pieces. A framework of thinking is needed to help fit all the pieces together successfully. That's where the "integrated theory" of business valuation comes in. This is a concept put forth by Chris Mercer and Travis Harms (both with Mercer Capital), who explain it in a series of BVR webinars.

When you listen to Mercer and Harms, it seems as if everything you've learned about business valuation comes together in a very logical and understandable way. They contend that any question or challenge an analyst faces can be answered by

1 appraisers.org/asa-newsroom/article/2021/02/26/report-requirement-changed-for-business-valuation-am-candidates.

2 corporatevalue.net/cvga.

3 providercompensation.org.

paying attention to three elements: cash flow, risk, and growth expectations. True, it may seem as if you've heard this before, but not in the way they present it, which makes it all fit together very nicely. They also do a very enlightening demonstration of how the three approaches to value (income, market, and asset) are interrelated.

The first installment of the webinar series gave an overview of the integrated theory, and the second installment examined enterprise cash flows. The third and final installment of the series will be April 21, when they will delve into shareholder cash flows.[4] BVR Training Passport holders have access to archive recordings of the first two, and they have a pass for the third. This series will definitely become a classic!

Blast from the past on forecasting

During a recent BVR webinar, Josh Shilts (Shilts CPA PLLC) mentioned a helpful article that appeared in the *Harvard Business Review,* "How to Choose the Right Forecasting Technique."[5] After reading the article, Shilts realized that it was written in 1971! But what it covers still holds true, he says. It covers the basic features and limitations of classic forecasting techniques, including qualitative methods, time series analysis, and causal methods. There's a nice chart that compares the different techniques and includes typical applications, computation times, accuracy ratings, reference material, and more. "This was gold to me when I found it," he says.

Research, Surveys, Data

Updated DealStats Companion Guide now available

The DealStats public- and private-transaction database has a newly revised Companion Guide[6] that reflects updated charts, graphs, and exhibits. The guide also covers recent enhancements made to the platform, such as the inclusion of the weighted harmonic mean. Also, the platform now allows a guest search so that a nonsubscriber can fully utilize the "Quick Search" and "Search" tabs to view limited information on the "Data" tab.

Another enhancement was made to the download option for "Only Displayed Fields" and "All Available Fields," which now includes a second worksheet, which contains the "Summary" tab information (so users have a record of their search criteria, their selected/deselected transaction IDs, and their summary statistics).

SPAC transactions included in 2021 *Mergerstat Review*

The special purpose acquisition company (SPAC) flourished during 2020, and SPAC transactions are included in the 2021 edition of the *Mergerstat Review.*[7] A SPAC is a shell company that raises capital in an IPO and then acquires an operating company to form a new merged entity. The *Mergerstat Review* features tables to highlight aggregate deal volumes and deal values for your analysis. Also, the FAQ page has been updated for the new edition. The 2021 edition will be available in mid-April in PDF format and early May for the print edition.

Mergerstat Review is an annual publication (with monthly updates) that presents compiled statistics relating to U.S. and cross-border mergers and acquisitions that involve both publicly traded and privately held companies. Data on M&A announcements and purchase prices are presented annually and quarterly, for the current period and historically, including details on individual deals and trends in prices, methods of payment, multiples, and premiums.

Goodwill impairments fell 10% in 2019: D&P study

Total goodwill impairment declined to $71 billion in 2019, down 10% from $78.9 billion in 2018, according to the "2020 U.S. Goodwill Impairment Study" by Duff & Phelps.[8] Although impairments dropped, this was the second highest level after the 2008 financial crisis, the study says. The study examines general and industry goodwill impairment (GWI) trends of more than 8,800 U.S. publicly traded companies through December 2019. The top three industries with the largest increase in GWI in 2019 were communication services, information technology, and consumer staples. This edition also gives a preview of the impact of the COVID-19 pandemic on goodwill impairments taken by U.S.-based public companies. "At the time of writing,

4 sub.bvresources.com/TrainingEvent.asp?WebinarID=1641.

5 hbr.org/1971/07/how-to-choose-the-right-forecasting-technique.

6 bvresources.com/docs/default-source/free-downloads/dealstats-companion-guide.pdf?sfvrsn=dd1cfb2_28.

7 bvresources.com/products/factset-mergerstat-review-2021.

8 duffandphelps.com/insights/publications/goodwill-impairment/2020-us-goodwill-impairment-study.

the disclosed top 10 GWI events for 2020 reached a combined $54 billion, far surpassing the top 10 in 2019 (at $37.4 billion)," the study says.

McKinsey examines consumer goods and retail in the wake of COVID-19

Consulting firm McKinsey has some very useful economic and industry reports, research studies, and regular briefings. The latest briefing (dated March 17) assesses the long-term effects of COVID-19 on the consumer goods and retail sectors.[9] In consumer goods, company performance has been "all over the map" as growth soared in 2020 but with the large firms capturing the lion's share. In retail, success in a post-COVID-19 world will require "hastened progress" on several long-standing imperatives and some new strategies. One of these long-standing mandates, of course, is the shift to "omnichannel," led by digital shopping. Too many retailers are still making decisions based on a brick-and-mortar mindset.

9 mckinsey.com/business-functions/risk/our-insights/covid-19-implications-for-business.

A lot of free material is available from McKinsey on economic and industry analyses, particularly with respect to the COVID-19 crisis. For example, one chart shows projected small-business recoveries by industry and another shows the most likely scenario for COVID-19's impact on domestic GDP in various countries.[10] All of this material is free, and you can sign up for regular alerts on the McKinsey website.

Data breaches threaten brand values, says study

A recent study from Infosys and Interbrand analyzes the maximum risk of brand value loss in case of data breaches.[11] For the "100 Best Global Brands" ranked in the 2020 Interbrand list, the maximum risk amounts to a loss of 11% of brand value.

10 mckinsey.com/~/media/McKinsey/Industries/Public and Social Sector/Our Insights/US small business recovery after the COVID 19 crisis/US-small-business-recovery-after-the-COVID-19-crisis-vF.pdf; mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/nine-scenarios-for-the-covid-19-economy.

11 infosys.com/services/cyber-security/insights/long-term-cost-data.html.

"While this figure doesn't look dramatic, it can translate to more than 100% of net annual income, depending on sectors," the folks at MARKABLES said in a statement.[12] MARKABLES is a provider of data designed to support the valuation of IP assets. The authors of the study suggest that brand owners should re-evaluate "hygiene" aspects of customer experience, such as cybersecurity. MARKABLES adds that brand owners should establish the value of their brands, quantify the risk they are exposed to, and rethink their approach to both risk avoidance (cybersecurity) and risk management (brand insurance coverage).

Cost of Capital

Pepperdine private cost of capital project is back up and running

On the brink of ending its long run, the Private Capital Markets Project from Pepperdine University has secured funding to continue its ongoing survey of expected rates of return of providers in the private capital market.[13] "I am very pleased to announce that we are back up and running due to generous underwriting from the ESOP Association and Employee Ownership Foundation," says Dr. Craig R. Everett, the project's director. This has enabled the project to launch a new cost of capital survey. "We know how important this study is to the ESOP and valuation communities, and we are pleased to ensure that this important independent source of data will continue to be provided to ESOP companies and valuation experts alike," Patrick Mirza, director of communications for the ESOP Association and Employee Ownership Foundation, told us.

Using public-market data to estimate the cost of capital for a private company requires many assumptions and adjustments to convert data from actively traded stocks into proxies for private-company valuation. Pepperdine's project, which produces the annual "Private Capital Markets Report" (available for free), provides an alternate analysis. The analysis is based on an ongoing survey of expected rates of return of investors, lenders, and business owners with respect to private companies. A *BVWire* poll in 2019 found that 40% of respondents use the Pepperdine reports.[14] Some practitioners use the reports as a sanity check on more traditional methods, and some use them as a primary method for estimating small private-company cost of capital.

New survey open: For this year's Pepperdine survey,[15] input is sought from anyone involved in the funding of private businesses, including funding providers, recipients, investors, intermediaries, and advisors. The information you provide is confidential.

Miscellany

Will the future of BV be in good hands?

The answer is a definite "yes," and the key factor will be the willingness of the new generation of practitioners to give back to the profession. The future of the valuation profession depends on contributions practitioners make to the advancement of the profession, says a panel of seasoned experts on a BVR webinar.[16] Giving back includes volunteering on committees at their respective organizations, contributing articles, writing books, and conducting conference sessions and webinars. The panel noted that, whether it be the ASA, AICPA, NACVA, or whatever organization you belong to, there are opportunities to contribute. All of the organizations have made efforts to attract young talent to serve on committees and contribute to education and marketing activities. Another way of fostering future leaders is through writing and speaking opportunities. For example, the panel noted that the upcoming new edition of Shannon Pratt's classic text *Valuing a Business* will have seasoned experts and young rising stars co-writing chapters.

The panel, moderated by Jay E. Fishman (Financial Research Associates), consisted of Michelle F. Gallagher (Adamy Valuation), Ken Pia (Marcum), and Jeffrey S. Tarbell (Houlihan Lokey). The webinar was the first in a new series of "power panel" programs that bring together highly experienced thought leaders in the profession to address current issues via questions from the audience.

12 markables.net/brand-value-risk-from-data-breach.

13 bschool.pepperdine.edu/institutes-centers/centers/applied-research/research/pcmsurvey.

14 bvresources.com/articles/bvwire/interesting-results-from-our-cost-of-capital-survey.

15 pepperdine.qualtrics.com/jfe/form/SV_6rgU11Uj6TTzTQq?region=34582.

16 sub.bvresources.com/trainingeventpast.asp?WebinarID=1636.

Global *BVU* News and Trends

Business valuation news from a global perspective.

Regulators, Standard-Setters, VPOs

IVSC proposes valuer 'governance' additions to IVS

In the last issue, we reported on the changes the International Valuation Standards Council (IVSC) is proposing to International Valuation Standards (IVS) section 200 regarding the definition of business interests. Another proposed addition to the current standards involves further definition of adequate procedures required in a business valuation. These "Proposed Changes to IVS 102 *Investigations and Compliance"* provide additional clarification to the General Standards, say IVSC. Here's the language of the new standard (comments may be submitted via IVSC.org):

> 40. Governance
>
> 40.1. Valuation processes should be governed in order to ensure high quality valuations. Governance should clarify the roles and responsibilities of the parties involved in the valuation process.
>
> 40.2 A systematic approach should be used in order to ensure sound valuation results. Governance over the valuation process should include considerations such as:
>
> 1. Independence and professional skepticism of those involved in the valuation process to make certain that the valuation is free from bias.
> 2. Pre-planning to establish a sound approach that addresses all relevant valuation factors.
> 3. Consistent and systematic processes to help provide completeness and accuracy.
> 4. Internal controls to check findings and judgements at various steps of the valuation process.
> 5. Transparency into the valuation approach(es) that were used and the factors that resulted in that determination.
> 6. Documentation (see IVS 102 Investigations and Compliance, Section 30 Valuation Record and IVS 103 Reporting) that includes a demonstrable understanding of the contractual and performance features of the unit being valued and how they are each addressed in the valuation.
>
> 40.3. Governance should clarify the roles and responsibilities of the parties involved in the valuation process.
>
> 40.4 Controls should be in place to verify the quality and observability of the inputs and tools used in the valuation process, including:
>
> 1. Sources for reliable and observable data.
> 2. High quality modelling systems, as applicable.

New IACVS chapter formed in India

The International Association of Certified Valuation Specialists (IACVS) has a newly formed chapter in India with a board consisting of reputed valuers from across the country.[1] The goal of the India chapter is to bring best-in-class global training and knowledge to its members and keep them up to date with valuation and fraud developments from across the world. The IACVS is a globally recognized association of business valuation professionals, with professional members in more than 50 countries. The organization issues the International Certified Valuation Specialist (ICVS) and ICVS with advanced studies in financial instruments (ICVS-A) credentials to qualified individuals.

Registration opens for CBV Congress 2021

The full agenda is now available, and you can now register for the CBV Congress 2021, held by the Chartered Business Valuators Institute (CBV Institute), Canada's valuation professional organization (VPO).[2] This is a three-day event that will be online

1 iacva.org.

2 cbvinstitute.com/events/cbv-congress-2021.

June 16-18. The first day is devoted to business valuation, and there will be a keynote by Dr. Aswath Damodaran (New York University Stern School of Business). The second day will examine the world of litigation, and the third is devoted to recent trends in M&A.

Books, Research Papers, Studies, Data

New IVSC paper on business valuations and ESG

Although there is an increased awareness in environmental, social, and governance (ESG) factors, there is no common approach on how to reflect ESG in business valuations. That's the topic of a new perspective paper from the International Valuation Standards Council (IVSC) that represents an early step "on the path toward a more systematic approach to the incorporation of ESG into business valuation practice and standards," the organization says.[3] The IVSC had a recent panel discussion, Unlocking the Value of ESG, and a recording of that is available.[4] The IVSC would like to hear your views on this paper and on ESG as it relates to valuation. Share your feedback by emailing contact@ivsc.org or through the IVSC Group page on LinkedIn.[5]

Country Views

Eurozone: Private M&A soars despite COVID-19

Private equity acquisition prices in the eurozone soared to a new record, according to the free Q4 2020 Argos Index, confirming an overheated rebound to what now appears to be a business value "blip" caused by COVID-19.[6] The Argos Index measures private midmarket-company valuations. What did private equity pay unlisted European SMEs during the fourth quarter? Deal volumes dropped, but the new record multiple climbed to 11.1x EBITDA. Conducted since 2006 by Epsilon Research for Argos Soditic, the index is calculated based on the information contained in the Epsilon Multiple Analysis Tool (EMAT), the database of European acquisition multiples and deal analysis reports (€1 million-to-€500 million deal value).

3 ivsc.org/news/article/perspectives-paper-esg-and-business-valuation.

4 ivsc.org/news/article/podcast-unlocking-the-value-of-esg.

5 linkedin.com/company/ivsc.

6 epsilon-research.com/Market/Argos.

DACH/Benelux: PwC examines working capital

An interesting analysis of how the COVID-19 pandemic has put cash and working capital into the limelight is in the 2021 edition of PwC's annual "Working Capital Report," DACH and Benelux regions.[7] DACH is comprised of Germany, Austria, and Switzerland, while the Benelux region is made up of Belgium, the Netherlands, and Luxembourg. The report points out an important fundamental: "Cash tied up in working capital provides no yield." Stockpiling cash to ease the way to recovery is certainly valid, but the key to driving value will be the optimal management of working capital. "Now is the right time to focus on cash and working capital management," the report says. "Not prioritizing cash is both ignoring an opportunity to drive value and risking a negative impact on cash flow."

United Kingdom: KPMG summary of the deal market rebound in 2H20

Business valuers trying to provide an economic overview (as required by IVS, RICS, ASA, and most international valuation standards) can be forgiven if they struggle describing 2020 and forecasting 2021.

KPMG's latest study of UK transactions involving private equity investors indicates that a total of 889 deals were completed over the course of 2020, with a combined value of GBP87.2 billion. This was the fewest number of private equity transactions seen in the UK since before 2014 and a fall of 26% from the previous year. KPMG concludes that midmarket PE deals were particularly impacted. Jonathan Boyers, head of M&A for KPMG in the UK, says: 'Once the initial shock of lockdown had worn off, and after a number of years of hesitancy caused by issues such as Brexit, general elections and broader international uncertainty, we saw a renewed urgency amongst private equity investors to get deals done. They had plenty of cash ready to be deployed, and with a similar appetite for transactions in the debt markets, it wasn't long before the M&A tap was turned back on.'

The KPMG forecast remains upbeat. Boyers says: 'We're certainly not seeing any signs that the latest lockdown is quelling momentum. Rather, there seems to be a mindset that nobody wants 2021 to be another "lost year" after such a prolonged period of economic and geo-political uncertainty.'

7 pwc.de/de/deals/working-capital-report-2021-dach-and-benelux-regions.pdf.

BVLAW CASE UPDATE

Featured Case

Fla. Trial Court's Valuation Findings, Including Personal Goodwill Determination, Do Not Hold Up Under Appeals Court Scrutiny

***King v. King,* 2021 Fla. App. LEXIS 3170, 2021 WL 822476, 46 Fla. L. Weekly D 498 (March 4, 2021)**

Summary. This divorce case appeal deals with three primary issues: The determination of the value of insurance agency marital asset; the determination of the amount of personal goodwill attaching to the insurance agency; and the appropriate amount of alimony. The court remands the value of the business as it relates to the exclusion by the trial court of the liabilities owed by the business; remands as to the appropriate amount of personal goodwill; and remands as to the erroneous level of income of husband for determination of alimony.

Case digest. The appeals court was faced with the following issues in this case, all asserted by the former husband: that the court overvalued the worth of the insurance agency the parties owned and undervalued the personal goodwill of former husband, that the trial court erred in determining the alimony award to the former wife, and that the trial court erred in ordering the former husband to maintain a life insurance policy to secure alimony and child support.

Background. The divorcing parties bought King Insurance Agency (KIA) from the former husband's parents five years prior to the dissolution proceedings. The former husband managed the operations and sold insurance as one of KIA's largest revenue producers. The parties paid $1.5 million plus assumption of KIA's debt for the agency. The parties agreed that KIA was marital property but could not agree on the value of KIA nor on the amount of personal goodwill attributable to the former husband.

Gary Trugman, the expert for the former husband, valued KIA using two methods: the market approach, comparable company transaction method, and the income approach. For the market approach, he used the DealStats database to determine comparable company transactions and arrived at a value of $3,223,083. The value determined under the income approach was $1,489,769. He determined the final value by allocating 75% of the market approach value and 25% of the income approach value. From that combined value, he deducted $724,833 of liabilities for a final concluded value of $2,065,000. Richard Gray, the expert for the former wife, arrived at a value under the income approach of $4,061,000. He did not deduct any liabilities.

Trugman determined the former husband's personal goodwill based on a with-and-without calculation, considering the former husband's revenues generated, at $1,600,544, or 68% of the company's value. Gray, using the comparable company database to determine values of covenants not to compete, determined a value for personal goodwill of 7.3% of the value of the company.

The trial court determined the value of the company to be worth $3,223,083, or Trugman's market approach value. It did not reduce that value by the liabilities. The trial court also determined the personal goodwill to be 7.3% of the value of KIA. Finally, the trial court decided that the former wife needed $12,000 per month in alimony and determined that the former husband had the ability to pay that amount.

Analysis. The appeals court determined that the trial court's determination of the value of KIA was not supported by competent, substantial evidence as required by Florida case law. Since the trial court failed to take into account any of KIA's liabilities, it overvalued KIA's fair market value. "This was error because no competent, substantial evidence in the record supports the trial court's valuation of KIA." The court reversed the valuation decision of the trial court.

As to personal goodwill, the court concurred that Florida law supports the exclusion of personal goodwill from the value of the business in a marital estate. In the *Thompson* case, the court explained that personal goodwill represents a person's probable future earnings, which should not be part of the value of a business (in that case, a professional practice). The court said, "This is because personal goodwill attributable to the skill, reputation, and continued participation of an individual is not a marital asset." In analyzing the determination by Gray of a 7.3% "figure," the court noted that Gray "did not provide any specific knowledge about the particulars of the insurance businesses that reported transactions in the DealStats database." Gray did not disclose whether the owners of those businesses also sold insurance, how involved in the business they were, or anything about the day-to-day operations. Also, many of the transactions occurred outside of Florida. For these reasons, the court reversed the decision on personal goodwill and remanded on the issue.

As to alimony, the trial court's decision that the former husband could afford $12,000 per month was based on a determination of his income that included undistributed income from an S corp (KIA). The court determined that the former husband had met his burden of proof that much of KIA's pass-through income was retained for the corporate purposes of paying debt or liabilities. This was error, according to the court, and the court also reversed that issue.

In conclusion, the court summarized that "[w]e reverse the final judgment and remand … the Trial Court's determination of the value of KIA … of Former Husband's personal goodwill in KIA, and in its award of alimony based on its erroneous calculation of Former Husband's income." ◆

***BVLaw* subscribers can access digests of court decisions and the original court opinions, and new cases are added every month. This table provides an overview of the latest case discussions added to the *BVLaw* platform. To read the complete digest of the listed cases, subscribe to *BVLaw* by visiting bvresources.com/bvlaw.**

Latest Cases Added to *BVLaw*

Case Name/ Full Citation	Experts	Case Type	State/ Jurisdiction	Digest Summary
King v. King 2021 Fla. App. LEXIS 3170, 2021 WL 822476, 46 Fla. L. Weekly D 498 (March 4, 2021)	N/A	Marital Dissolution/ Divorce	Florida	This divorce case appeal deals with three primary issues: the determination of the value of insurance agency marital asset, the determination of the amount of personal goodwill attaching to the insurance agency, and the appropriate amount of alimony. The court remands the value of the business as it relates to the exclusion by the trial court of the liabilities the business owed, remands as to the appropriate amount of personal goodwill, and remands as to the erroneous level of income of the husband for determination of alimony.
Aspro, Inc. v Commissioner T.C. Memo 2021-8, 2021 Tax Ct. Memo LEXIS 6 (Jan. 21, 2021)	Ken Nunes	Federal Taxation	Federal	The U.S. Tax Court recently agreed with the Internal Revenue Service that management fees a corporation paid to its three shareholders over a three-year period were not deductible since none of the fees were paid "purely for services" and the petitioner failed to show the fees were "ordinary, necessary, and reasonable." Rather, they represented disguised distributions, the court found.
Estate of Warne v. Commissioner T.C. Memo 2021-17; 2021 Tax Ct. Memo LEXIS 22 (Feb. 18, 2021)	Stephen Roach, Phillip Schwab, Jared Eichorst (Estate); Bradley Lofgren, Espen Robak (Commr.)	Federal Taxation	Federal	In a gift and estate tax dispute, the estate and Internal Revenue Service agreed to apply discounts for lack of control and marketability to the majority interests in a number of real estate holding companies. The U.S. Tax Court noted that, in prior decisions, the court found no discount for lack of control applied. However, given the parties' agreement, here, the court said it would apply a "slight" or "low" discount.
Derek Scott Williams PLLC v. Cincinnati Ins. 2021 U.S. Dist. LEXIS 37096 (Feb. 28, 2021)	N/A	Economic Damages & Lost Profits	Federal/Northern District of Illinois, Eastern Division	In this business interruption case resulting from mandatory shutdowns to control COVID-19, the court declined to grant a motion to dismiss the claim of plaintiff as to coverage for loss of business income but does dismiss the claim of coverage under the civil authority provision of the policy. The court found the wording of the policy sufficiently vague, especially as to the meaning and definition of the word "loss." In the case of the civil authority provision of the policy, the court decided that plaintiff has not alleged that "[a]ccess to the area immediately surrounding the damaged property is prohibited by civil authority."
Innovation Ventures, L.L.C. v. Custom Nutrition Labs., L.L.C. 2021 U.S. Dist. LEXIS 28254; 2021 WL 598545 (Feb. 16, 2021)	Rodney Crawford (plaintiff); Dr. Christopher Pflaum (defendant)	Economic Damages & Lost Profits	Federal/Eastern District of Michigan, Southern Division	This case involves a consideration of motions by both the plaintiff and the defendant to exclude the testimony of the other party's expert witness on the basis of *Daubert* and the Federal Rules of Evidence. The plaintiff's expert offered testimony on how to calculate lost profits based on the plaintiff's market share. The defendant's expert offered testimony as to weaknesses in the plaintiff's calculations and opinions on damages. The court denied both of these cross-motions.
Equity Planning Corp. v. Westfield Ins. Co. 2021 U.S. Dist. LEXIS 36452 (Feb. 26, 2021)	N/A	Economic Damages & Lost Profits	Federal/Northern District of Ohio	In this business interruption case resulting from mandatory restrictions to control COVID-19, the court grants a motion to dismiss claims of the plaintiff. The plaintiff's arguments that it suffered physical loss or damage to its properties did not sway the court. Nor did its arguments that the civil authority provisions and virus exclusion in the policy were not applicable to deny its claims.
Family Tacos, LLC v. Auto Owners Ins. Co. 2021 U.S. Dist. LEXIS 29774 (Feb. 17, 2021)	N/A	Economic Damages & Lost Profits	Federal/Northern District of Ohio, Eastern Division	In this business interruption case resulting from mandatory shutdowns to control COVID-19, the court grants motions of the defendant to dismiss claims of the plaintiff. The plaintiff files claims for coverage under its insurance policy for losses resulting from COVID-19 shutdowns and seeks to establish a class. The court decides that coverage is not provided under the policy because there is no physical loss; the civil authority provision is likewise not effective, and there is a virus exception that is applicable to the case at hand.

BVR TRAINING EVENTS

To register for any of our events, or for more information, visit bvresources.com/training or call 503-479-8200. For subscription access to BVR events, please visit bvresources.com/passport.

Houston's ASA Energy Valuation Conference: A BVR Live Webcast
May 12, 6:15 a.m. PT-3:15 p.m. PT/9:15 a.m. ET-6:15 p.m. ET
Featuring an expert panel

Illiquidity Discounts for Restricted Equity Securities With Random or Indefinite Liquidity Horizons
Special Series on Advanced Modeling and Methodologies
May 19, 10:00 a.m.-11:15 a.m. PT/1:00 p.m.-2:15 p.m. ET
Featuring: Stillian Ghaidarov

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CALENDAR

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www.aicpa.org

2021 ASA Complex Securities Virtual Conference
May 20
www.appraisers.org

2021 ASA Fair Value Virtual Conference
June 10
www.appraiser.org

ESOP 44th National Conference (Virtual and Live Conference)
June 21-23
Washington, DC
www.esopassociation.org

2021 Business Valuation and Financial Litigation Hybrid and Virtual Super Conference
June 21-25
Park City, UT
www.nacva.com

AM&AA Summer Conference
July 28-30
Dallas, TX
www.amaaonline.com

IBBA 2021 Annual Conference
October 15-16
Woodlands, TX
www.ibba.org

2021 ASA International Conference (Virtual and Live Conference)
October 24-26
Las Vegas, NV
www.appraisers.org

AICPA and CIMA Forensic and Valuation Services Conference (Virtual and Live Conference)
November 8-10
Las Vegas, NV
www.aicpa.org

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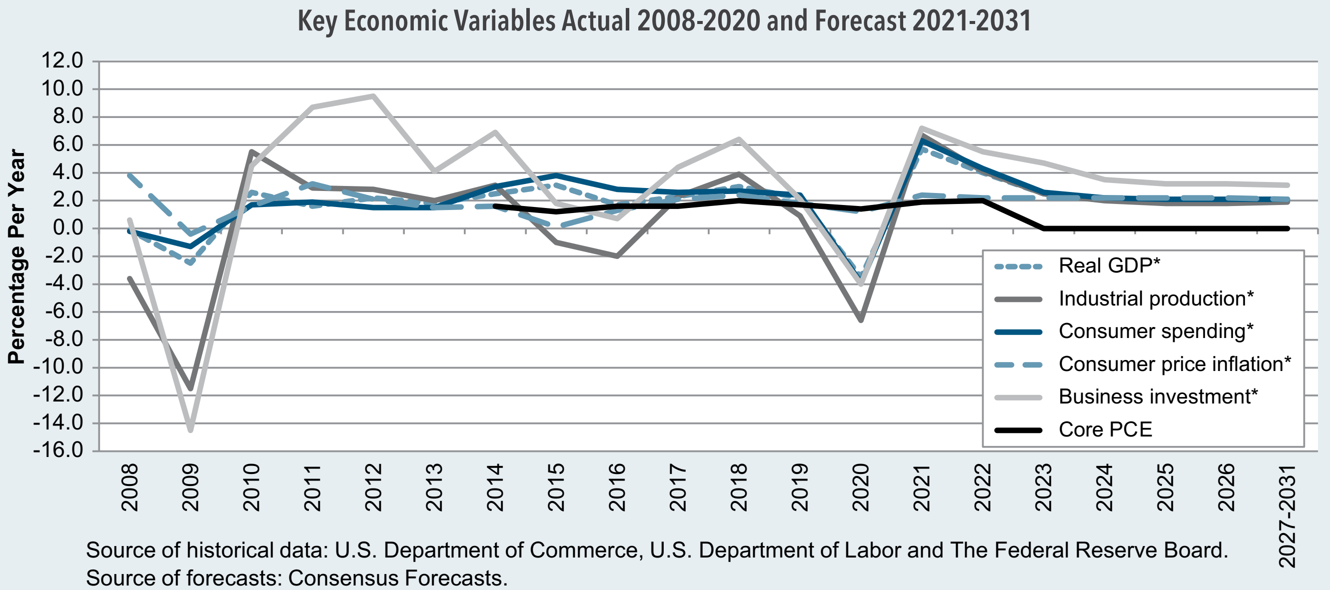
BUSINESS VALUATION DATA SPOTLIGHT

Economic Outlook for the Month



Source of historical data: U.S. Department of Commerce, U.S. Department of Labor and The Federal Reserve Board.
Source of forecasts: Consensus Forecasts.

*Numbers are based on percent change from preceding period. Consumer price inflation information is annual averages.

Quarterly Forecasts 2Q 2021-4Q 2021 and Annual Forecast 2021-2022

	Quarterly			Annual			
	2Q 2021	3Q 2021	4Q 2021	2021	*(prior forecast)*	2022	*(prior forecast)*
Real GDP*	7.6	7.0	4.6	5.7	*4.7*	4.0	*3.6*
Consumer spending*	8.5	7.9	4.9	6.3	*5.2*	4.3	*3.8*
Business investment*	6.1	7.3	6.3	7.2	*6.1*	5.5	*5.3*
Consumer price inflation*	2.3	2.1	2.3	2.4	*2.3*	2.2	*2.2*
Real disposable personal income*	-2.6	-8.6	-3.2	2.1	*1.3*	-1.1	*-0.1*
Unemployment rate	5.8	5.3	5.0	5.6	*5.9*	4.4	*4.7*
Industrial production*	5.9	6.3	4.6	6.7	*5.5*	4.1	*3.7*

Source of forecasts: *Consensus Forecasts - USA*, March 2021.

Notes: Quarterly figures are percent change from prior quarter, at seasonally adjusted annual rates (except unemployment which is the average for that period).

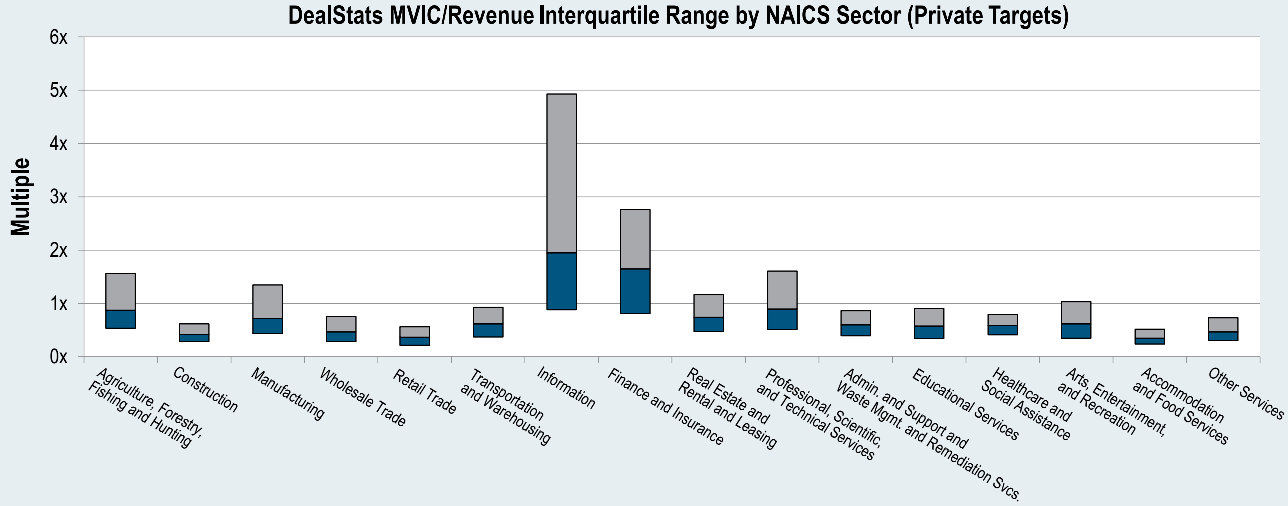
Annual rates are percent change from preceding period (except unemployment, which is the average for that period).

Every month, Consensus Economics surveys a panel of 30 prominent United States economic and financial forecasters for their predictions on a range of variables including future growth, inflation, current account and budget balances, and interest rates.

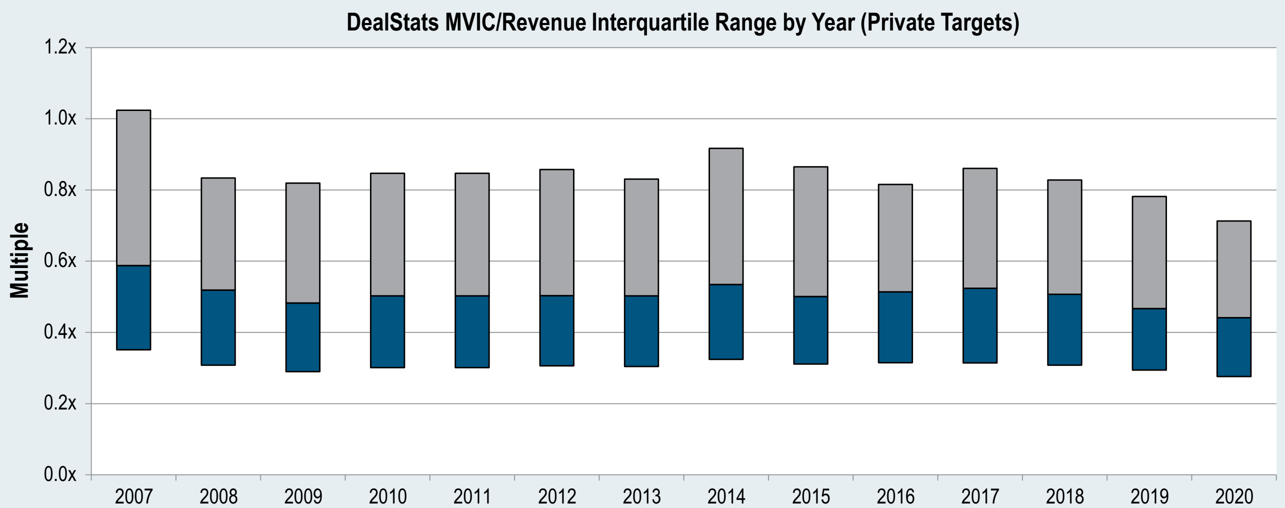
This section is an excerpt from BVR's *Economic Outlook Update* (*EOU*).[1] The *EOU,* a convenient and cost-effective resource, provides a review of the state of the U.S. economy and forecast for the future. Leading experts in the BV profession rely on the *EOU* as the basis for the current economic conditions and forecast portions of their valuation reports. ◆

1 The *Economic Outlook Update* is published monthly and quarterly by Business Valuation Resources, LLC (BVR). Visit bvresources.com/EOU or call 503-479-8200, ext. 2.

MVIC/Revenue Trends



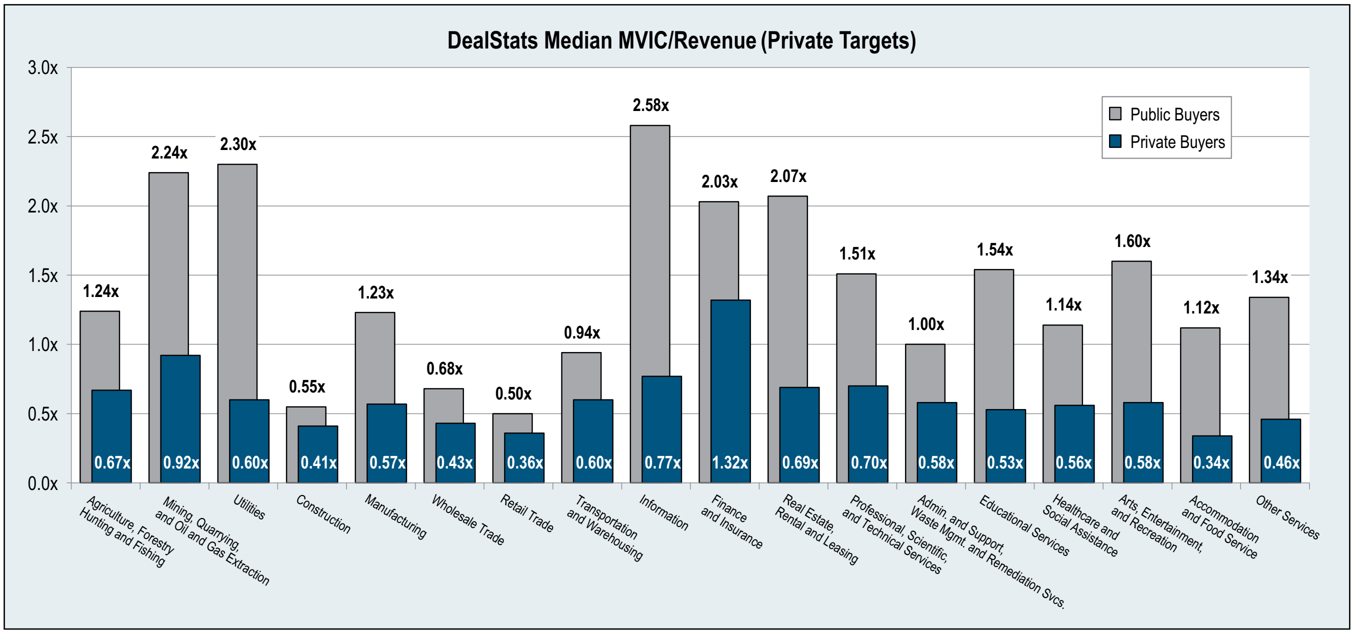
Note: The interquartile range describes the middle 50% of observations. The top of the grey rectangle indicates the 75th percentile, the bottom of the blue rectangle indicates the 25th percentile. The line where the two rectangles meet represents the median. If the interquartile range is large, it means that the middle 50% of observations are spaced wide apart, and, if the interquartile range is narrow, it means the middle 50% of observations are spaced close together.



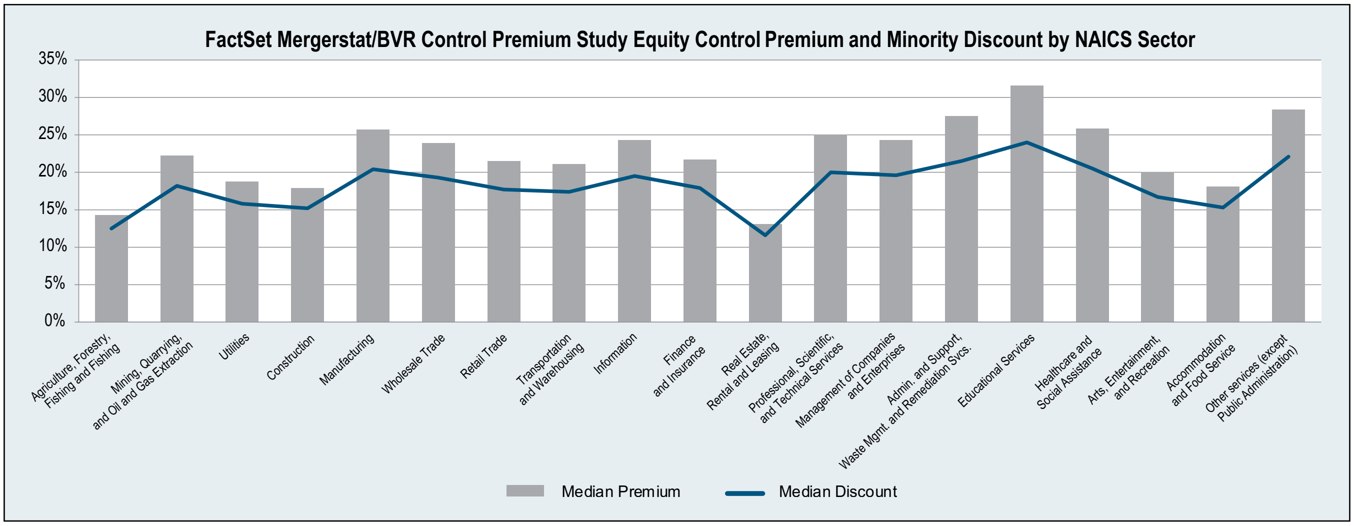
The first two graphs display the interquartile range of the MVIC/revenue multiple by major NAICS sector and by year from the DealStats (formerly Pratt's Stats) database for private targets.[1] For the period analyzed, the information sector had the greatest median MVIC/revenue multiple and was also the sector with the largest dispersion between the first and third quartiles (25th percentile and 75th percentile). The accommodation and food service sector had the lowest median MVIC/revenue multiple and the least dispersion in its interquartile range. When reviewing the data by year, the median MVIC/revenue multiple has consistently been between 0.4 and 0.6. In recent years, it appears that there has been less dispersion in the MVIC/revenue interquartile range when compared to past years. The graph on the next page compares the median MVIC/revenue multiples paid by private acquirers to the multiples paid by public acquirers. In each of the 18 industry sectors, public buyers paid higher multiples than private buyers. The greatest difference in multiples between private and public buyers occurred in the information sector.

1 In DealStats, market value of invested capital (MVIC) is the term used for selling price. In addition to showing the median valuation multiple by sector and year, the interquartile range provides a measure of dispersion. DealStats is available from Business Valuation Resources, LLC (BVR). Visit bvresources.com/dealstats, or call 503-479-8200, ext. 2.

DealStats is a private- and public-company transaction database, which provides financial details on over 40,800 acquired businesses. DealStats is used as a comparable transaction data source for sold businesses across all industry sectors. To learn more, visit bvresources.com/dealstats. ◆



FactSet Mergerstat/BVR Control Premium Study



This graph displays the median equity control premium and median equity implied minority discount for all industries as organized by two-digit NAICS sector from the FactSet Mergerstat/BVR Control Premium Study. As the graph shows, with a few exceptions, the majority of sectors have median equity control premiums and equity minority discounts between about 15% and 25%. On the high end, one exception was the Education Services sector, which has an equity control premium of 31.6% and minority discount of 24.0%. On the low end, another exception was the Real Estate and Rental and Leasing sector, with an equity control premium of 13.1% and a minority discount of 11.6%. While specific comparables would be needed in a valuation to determine and support a control premium or minority discount, this graph is useful to compare control premiums and minority discounts by sector. More data, as well as detailed search tools, can be found in the FactSet Mergerstat/BVR Control Premium Study, available at bvresources.com/cps. ◆

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Business Valuation Resources, LLC
111 SW Columbia Street, Suite 750
Portland, OR 97201-5814

May 2021 Cost of Capital Center

General Monthly Cost of Capital Data

Treasury yields[1]	
30-day: 0.02% 5-year: 0.90% 20-year: 2.24%	
Prime lending rate:[1]	3.25%
Dow Jones 20-bond yield:[2]	2.42%
Barron's intermediate-grade bonds:[2]	3.00%
Dow Jones Industrials P/E ratios:[2] (Represents median figures)	
On current earnings:	35.1
Forward 12 month operating est.:	21.2
High yield estimate:[2]	
Mean: 4.8% Median: 4.9%	
Long-term inflation estimate:[3]	2.27%
1H 2021 rate of GDP growth:[4]	2.90%
2H 2021 rate of GDP growth:[4]	3.70%

BVR's Private Company Cost of Capital Index[5]

Company Revenue ($thousands)	Cost of Capital
1,000	18.9%
5,000	17.3%
10,000	15.6%
15,000	14.8%

BVR's Cost of Capital Professional[6]

	CRSP Equity Risk Premium	
Time Period	**Historical ERP (10Y T-Bond)**	**Historical ERP (20Y T-Bond)**
1928-2019	6.55%	5.91%
1950-2019	6.75%	6.13%
1960-2019	4.50%	3.82%
1970-2019	4.11%	3.12%
1928-2018	6.39%	5.80%
1950-2018	6.53%	5.95%
1960-2018	4.20%	3.58%
1970-2018	3.73%	2.82%

1 Source: The Federal Reserve Board as reported by the BVR Risk-Free Rate Tool, located at bvresources.com/riskfreerates.asp, April 1, 2021.

2 Barron's, March 29, 2021. Forward 12 months as of March 29, 2021.

3 Aruoba Term Structure of Inflation Expectations/Federal Reserve Bank of Philadelphia Forecasts for the average annualized rate of inflation over the next 10 years, March 31, 2021.

4 GDP Forecast, Federal Reserve Bank of Philadelphia, Livingston Survey, Dec. 18, 2020.

5 After-tax cost of capital (calibrated for 35% tax rate and mid-period convention) for average/typical risk company. For use on unlevered, after-tax expected free cash flows. Based on DealStats data and Dohmeyer, Burkert, Butler and Tatum's Implied Private Company Pricing Line (IPCPL). Numbers are provided by the IPCPL developers as of Oct. 4, 2018. See the IPCPL page at bvresources.com/ipcpl.

6 These data are sourced from BVR's Cost of Capital Professional online platform, which offers equity risk premia, size premia, and risk-free rates and allows you to compute cost of equity and WACC estimates. This powerful resource provides a simple and transparent way to estimate cost of capital. You will always see the components of your cost of capital, how the figures were calculated, and the citations of all sources used—everything you need to support your work. To learn more, visit bvresources .com/ccprofessional.