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Willamette Management Associates Insights

About This *Insights* Issue

This issue of *Insights* focuses on financial advisory services related to (1) merger and acquisition pricing and structuring, (2) fairness, solvency, insolvency, and other transaction opinions, (3) corporate bankruptcy and reorganization issues, (4) leveraged ESOP formations and stock transactions, and (5) strategic planning and asset rationalization. This issue also describes board advisory services related to (1) Sarbanes-Oxley Act corporate governance, (2) dissipation of shareholder wealth allegations, (3) management fraud or defalcation claims, and (4) accounting error or irregularity concerns. This issue also discusses private company investment banking services related to (1) ownership transition, (2) financing and recapitalization, (3) shareholder redemption, (4) financial

engineering, (5) strategic planning, and (6) equity allocation/security exchange ratios.

Willamette Management Associates provides independent financial advisor services to (1) public company directors, (2) private company owners, (3) ESOP trustees and lenders, (4) debtors in possession, (5) secured and unsecured creditors, (6) tax-exempt organization trustees, and (7) minority/dissenting shareholders. Willamette Capital provides client representation/private company investment banking services to (1) closely held corporation sellers, (2) employee, management, and other buyers, (3) private equity funds, (4) public companies making strategic divestitures, and (5) distressed companies seeking spin-off/debt restructuring opportunities.

ABOUT THE EDITOR

Robert P. Schweih

Bob Schweih is a managing director of both Willamette Capital and Willamette Management Associates. Before joining the firm in 1991, Bob was a partner and national director of valuation services at accounting firm Deloitte & Touche.



Bob's practice includes both (1) independent financial advisory services and (2) client representation financial advisory services. These services are performed for purposes of merger and acquisition, private company ownership transition, financing securitization and collateralization, ESOP formation and transactions, stock redemption, troubled debt restructuring, and not-for-profit taxation and regulatory compliance.

The independent financial advisory services include: (1) transaction opinions, (2) bankruptcy and reorganization services, and (3) restructuring and recapitalization analyses. The transaction opinions include (1) fairness opinions, (2) solvency opinions, (3) fair market valuations, (4) adequate consideration opinions, and (5) excess benefit opinions. These transaction opinions are typically issued by Willamette Management Associates.

The client representation/financial advisory services include: (1) business brokerage, (2) buyer representation and deal negotiation, (3) seller representation and deal negotiation, (4) private placement of debt and equity

securities, and (5) leveraged employee buyout structuring and financing. These private company investment banking services are typically performed by Willamette Capital.

Bob also provides valuation consulting services for purposes of federal income, gift, and estate taxation; state/local property taxation; ESOP/ERISA regulatory compliance; shareholder oppression and dissenting shareholder appraisal rights; family law; eminent domain and condemnation; breach of contract and other commercial litigation; and financial accounting "fair value" disclosures.

Bob has served as an expert witness on well over 50 occasions regarding the valuation of businesses, securities, real estate and personal property, and intangible assets and intellectual properties. He has testified in both valuation and economic damages/lost profits matters before federal, state, and local courts and tribunals.

Bob holds a B.S. degree in engineering from the University of Notre Dame and an M.B.A. in finance from the University of Chicago Graduate School of Business. He is a certified business appraiser and an accredited senior appraiser (with a specialization in business valuation).

Bob is the co-author of seven valuation textbooks, including the *Handbook of Business Valuation and Intellectual Property Analysis* (published in 2004) and the *Guide to ESOP Valuation* (published in 2005). And, Bob has authored well over 100 technical articles which have been published in numerous professional journals.

He has served for many years as a member of the editorial advisory board of *Business Appraisal Practice*, the professional journal of the Institute of Business Appraisers.

FINANCIAL ADVISER PROCEDURES TO HELP CLIENTS AVOID OVERPAYING IN MERGERS AND ACQUISITIONS

Robert P. Schweih

At the end of 2005, many industries are poised for a cycle of acquisitions and consolidations. Historically, the managements and boards of many industrial and commercial companies have been accused of overpaying for target acquisitions. This article describes practical procedures that financial advisers can use to help clients avoid overpaying for acquisition targets.

INTRODUCTION

Both a corporation's board of directors (or management) and a corporation's financial adviser should be interested that an acquirer does not pay more than a fair market value price in a merger and acquisition (M&A) transaction. This concern is appropriate whether the acquirer is a for-profit corporation or a not-for-profit institution. This concern is based on the board's obligation to comply (1) with the Sarbanes-Oxley corporate governance requirements and (2) with state statutes regarding dissipation of shareholder wealth.

This concern is based on the board's obligations as the custodian of either public assets (for a not-for-profit entity) or private assets (for a for-profit corporation). The directors (and the operating management) of the acquirer have an obligation (1) not to dissipate corporate assets and (2) to act in the best interest of their constituents.

In addition to corporate stockholders, M&A lending institutions are concerned that an acquirer does not pay more than fair market value, particularly with regard to leveraged acquisitions. In fact, all parties to a transaction have an interest in seeing that the acquirer does not "pay too much" in either a stock or asset acquisition.

Why Corporate Acquirers Often "Pay Too Much"

For purposes of this discussion, the term "pay too much" is defined as any one of the following conditions:

1. The acquirer pays a total consideration amount in excess of the target company's fair market value (i.e., the price a hypothetical willing buyer would pay to a hypothetical willing seller).
2. The acquirer pays a total consideration in excess of the target company's intrinsic value (i.e., the present value of the expected post-acquisition economic benefits to the acquirer).

3. The acquirer pays a total consideration that will result in a transaction internal rate of return (IRR) that is less than the acquirer's cost of capital.

By the middle of 2005, the national stock market indices (e.g., NYSE, Nasdaq, DJIA, and S&P) had recovered from a four-year downturn in investor returns. At the same time, M&A markets have generally rebounded—in terms of both deal volume/number of transactions and deal size/valuation pricing multiples. This rebound has occurred across both (1) industrial and commercial sectors and (2) M&A deal sizes.

Accordingly, this is an appropriate time for corporate acquirer managements and their financial advisers to (1) reflect on the overvaluation/overpricing mistakes of the last bull market and (2) develop and implement systematic procedures to minimize the potential for the acquirer to overpay for the next acquisition.

There are many reasons why a corporate acquirer may pay too much for a target company acquisition. Some of these reasons are industry-specific or organization-specific. And, some of the reasons are institutional. For example, investment bankers and sell-side financial advisers are often compensated for closing the deal at the highest negotiated price—and not for closing the deal at fair market value. Some of the reasons are structural. For example, sell-side financial advisers may price the deal according to a predetermined investment hurdle rate that may or may not equal the acquirer's cost of capital.

There are also human behavior explanations for why a corporate acquirer may pay too much. Sometimes employees become overly enthusiastic about the expected economic and social benefits of providing an expanded array of goods and services.

Discussion Objectives

After the last M&A market bubble burst, explanations for why acquirers overpaid were presented in both business and academic journals. In contrast to analyzing why corporate acquirers historically overpaid, this discussion focuses on procedures that can help an acquirer to avoid overpaying for its next target company acquisition. In other words, instead of examining the M&A sins of the past, this discussion focuses on due diligence and pricing procedures that will result in an economically sound conclusion in the next M&A acquisition.

These due diligence procedures relate to investigating, pricing, negotiating, and structuring the subject purchase transaction. These due diligence procedures are intended to:

1. result in a purchase transaction price and structure that are consistent with the acquirer's strategic and corporate finance objectives or
2. allow the acquirer to recognize and reject an overpriced transaction.

This discussion presents a “top 10 list” of financial adviser's M&A due diligence and transaction analysis procedures. These procedures can be used by the financial adviser to assist the directors/management to avoid an overpriced acquisition transaction. This financial adviser's list is not intended to be a comprehensive list of all M&A pricing and structuring procedures.

Rather, this list is intended to present procedures that are fundamental and yet frequently overlooked—even by an experienced director or financial adviser. This top 10 list is not presented in any particular order of importance or priority.

FINANCIAL ADVISER TRANSACTION VALUATION PROCEDURES

Financial adviser procedures 1 through 5 apply principally to the target company acquisition valuation. Financial adviser procedures 6 through 10 relate principally to structuring the target company acquisition transaction. All of these procedures are intended to assist the acquirer entity directors to avoid overpaying for the target company M&A transaction.

Financial Adviser Procedure 1—Consider Multiple Valuation Approaches and Methods

Many financial advisers are comfortable using the income approach and, specifically, the discounted cash flow (DCF)

method to value acquisition targets. The DCF method is conceptually sound and allows for a significant amount of analytical rigor. This method is well suited to analysis of (1) changing financial projections and (2) alternative valuation variables.

For example, the DCF method allows for the estimation of both (1) an equity value and an (2) enterprise (i.e., invested capital) value. And, the DCF method allows for value estimation based on alternative debt service, capital structure, and rate of return assumptions.

However, the DCF method is only one of several generally accepted income approach business valuation methods. And, the income approach is only one of several generally accepted business/security valuation approaches.

The financial adviser to a corporate acquirer should consider using several different direct capitalization and yield capitalization methods as part of an income approach valuation analysis. Likewise, the financial adviser should consider the use of alternative methods within the market approach and asset-based approaches to the valuation of acquisition targets.

The use of several different valuation approaches and methods may allow the acquisition financial adviser to:

1. develop a multi-faceted perspective of the target company value,
2. triangulate a pricing conclusion within a range of target company values,
3. consider factors and variables that are not emphasized in the DCF method,
4. identify aberrational value indications from within a reasonable range of potential transactional prices, and
5. quantify the level of sensitivity of price indications to small changes in the target company valuation model inputs.

Financial Adviser Procedure 2—Consider the Application of Asset-Based Approach Valuation Methods

Many transactional financial advisers are not particularly experienced with asset-based approach business valuation methods. In the asset-based approach, the business/professional practice value is the sum of the current values of (1) financial assets (e.g., receivables, inventory, investments), (2) tangible assets (e.g., real estate and personal property), (3) discrete intangible assets (e.g., contracts, copyrights, trademarks, workforce), and (4) goodwill, minus the current values of (1) short-term liabilities (to estimate enterprise value) and (2) long-term liabilities (to estimate equity value).

Typically, the more difficult aspects of asset-based approach methods are the identification and valuation of the target company off-balance-sheet, discrete intangible assets.

The asset-based approach methods often require more analytical time and effort than income approach or market approach valuation methods. These methods may also require a more rigorous acquisition due diligence investigation of the acquisition target than other business valuation methods.

However, the additional due diligence effort invested in an asset-based approach valuation analysis not only provides an additional value indication in the final pricing synthesis and conclusion. The additional due diligence effort also increases the reliability and documentation of all other valuation pricing analyses.

Because the asset-based approach requires the financial adviser to value all of the target company tangible and intangible assets, the valuation effectively creates a preliminary transaction purchase price allocation. This purchase price allocation can be used (1) to consider the pro forma effect of the transaction on the acquirer entity's financial statements and (2) to model the income tax implications of alternative transaction prices/structures.

The discrete asset valuations can be used to (1) analyze proposed transaction financing terms and (2) identifying sale/leaseback and other creative financial structures. Asset-based approach procedures help the financial adviser identify/quantify contingent liabilities (e.g., taxation, litigation, regulatory, environmental, etc.) that are not explicitly considered in other target company valuation approaches.

Financial Adviser Procedure 3—Quantify Both the Stand-Alone Fair Market Value and the Buyer-Specific Acquisition Value of the Target Company

Fair market value is generally defined as the price a typically motivated willing buyer would pay and a typically motivated willing seller would accept for the subject business enterprise. This definition of value generally considers only the economic benefits that would be available to the typical willing buyer of the acquisition target.

In other words, unique buyer-specific synergies and post-merger economic benefits should be excluded from a fair market value analysis. This definition of value generally considers only the assets that the acquisition target has available to sell on a stand-alone basis. In other words, intangible assets created (or enhanced) only as a result of specific buyer actions/attributes should be excluded from a fair market value analysis.

Acquisition value (also called investment value) is generally defined as the highest price a specific buyer would be

willing to pay to a specific seller for the subject target company, given a buyer-specific set of investment criteria. This definition of value generally considers the total expected economic benefits of the combined acquirer/target entity. In other words, buyer-specific synergies and post-merger economic benefits could be included in an acquisition value analysis.

Similarly, acquisition target intangible assets that are created or enhanced by the acquirer's financial/operational attributes would be included in the acquisition value analysis. In addition, the acquisition valuation analyses would be based on buyer-specific investment criteria—for example, discount rate, direct capitalization rate, and payback period. This is true even if these buyer-specific investment criteria are not consistent with market-derived valuation pricing variables.

Typically, the specific buyer's acquisition value is greater than the acquisition target stand-alone fair market value. Of course, this outcome is not a forgone conclusion. The target's acquisition value for a particular buyer (with an unusually high cost of capital, for example) may be lower than the target's fair market value.

Of course, in a competitive bidding situation, that particular buyer would never be the successful acquirer of the target entity. In a competitive market, that particular buyer could be easily outbid by the "typical" willing buyer. Accordingly, it is unlikely that a target company would ever sell for less than its stand-alone fair market value.

There are two reasons why transactional financial advisers should quantify both the fair market value and the acquisition value of the acquisition target. First, such an analysis requires the financial adviser to identify and quantify the expected merger-specific economic benefits. Second, such an analysis should help the financial adviser in negotiating the pricing for the subject M&A transaction.

There are several reasons why a transactional financial adviser should identify/quantify specific post-merger benefits. First, this procedure allows the financial adviser to assess whether the expected post-acquisition benefits will also be available to the entity acquiring the target company. Second, quantifying the expected post-acquisition benefits allows the financial adviser to estimate what a third party acquirer would offer as a competing bid to purchase the target company.

There are also several ways in which a financial adviser may use the expected post-merger benefits in the deal price and structure negotiations. It is noteworthy that certain types of acquirers (e.g., an ESOP or a not-for-profit acquirer) cannot pay more than fair market value for the acquisition target.

However, a sale to such an acquirer can often provide both financial and nonfinancial benefits to the sellers. The financial adviser may be able to quantify these transaction

benefits. Then, the financial adviser can demonstrate to the target company sellers that the economic benefits of the sale to the ESOP or not-for-profit acquirer are greater than the price increment associated with a specific buyer's investment value.

Financial Adviser Procedure 4—Perform a Sensitivity Analysis of the Important Valuation Variables

Among the sensitivity analysis scenarios, the transactional financial adviser should consider: (1) a valuation with the most likely post-acquisition financial projections and (2) a valuation of the post-deal “worst case scenario” for the acquisition target. There are several reasons why sensitivity analyses may be useful in the transaction pricing and structuring negotiations. These reasons are described below.

First, the sensitivity analysis can identify a range of possible values for the acquisition target. This would indicate that the financial adviser should not negotiate a transaction price outside of this range of possible values. Depending on the procedures performed, the sensitivity analysis may also identify probabilities associated with the possible value outcomes. This would allow the financial adviser to negotiate a price within the most likely range of possible values.

Second, the sensitivity analysis can identify the most sensitive valuation variables—that is, those variables where a small change in the variable input causes a large change in the value indication. It is important to identify the most sensitive valuation variables so that the financial adviser can subject those variables to a particularly robust due diligence investigation. It is also important to identify the most sensitive valuation variables so that the acquirer management can focus on those variables after the pending acquisition is closed.

Third, the sensitivity analysis can help quantify the risk of overpaying for the acquisition target. This is particularly true when the sensitivity analysis quantifies the values associated with (1) the worst case acquisition target scenario and (2) other pessimistic acquisition target scenarios. The sensitivity analysis should help the financial adviser to develop a clear understanding of the value implications of unfavorable acquisition target operating results.

Financial Adviser Procedure 5—Carefully Consider the Value Implications of Business Cycles with Respect to the Target Company, the Target's Industry, and the General Economy

Considerations of the relevant business cycles may be grouped into two categories: (1) the length and shape of the typical business cycle and (2) where the target company is

situated in the current business cycle as of the acquisition date. Business cycle considerations may affect the target company valuation in several ways.

First, most target company M&A financial projections indicate continuous increases in operating performance after the acquisition date. The financial adviser should consider if such a projection is inconsistent with the historically cyclical nature of the subject industry. The financial adviser should consider the current operating results compared to where the target company is in its current business cycle.

If the target company is currently at the nadir of its business cycle and approaching an expansionary phase, then increasing financial projections may not be unrealistic. However, if the target company is currently at the zenith of its business cycle and approaching a contractionary phase, then more conservative financial projections may be more reasonable. The financial adviser should consider the current stage of the target's industry business cycle when assessing the reasonableness of any target company financial projections.

Second, an analysis of where the target company industry currently sits on its industry business cycle can help identify the expected level of competition to the target company.

The current stage of the target company industry business cycle could affect: (1) expected product/service pricing, (2) expected product/service innovation and new product/service introductions, (3) the number of entities expected to enter/leave the industry in the short term, and (4) the general level of supply and demand for products/services in the target's industry.

Third, an analysis of where the regional/national economy sits in the general economic cycle can help identify expected changes in the macroeconomic factors that influence the target company valuation.

The current phase of the general economic cycle could affect: (1) expected interest rates, (2) the availability of capital for target company expansion plans, (3) the expected price inflation and cost inflation in the target's industry, (4) the availability/price of professional/support employees in the target's industry, and (5) the relative pricing (due to exchange rates) of foreign demand/competition for the target industry products/services.

Financial Adviser Procedure 6—Structure the Target Acquisition Transaction so that the Seller Has a Continued Interest in the Success of the Target Company

This procedure involves the financial adviser's structuring the target company acquisition transaction. This procedure includes deal structure provisions such as: the use of seller

contractual earn-out provisions, step-purchase transactions, and seller retention of some class of equity security.

The objective of these contractual provisions is to have the target company seller and/or target company key employees continue to have an economic interest in the success of the target entity. There are two reasons to use such provisions in M&A transactions.

First, it is not unusual for both (1) the seller (as an individual or a corporate entity) and (2) key employees to have an economic incentive to make the target company acquisition successful. It would then be in their economic self-interest to focus on achieving the greatest subsequent payments in the earn-out/step-purchase/retained equity redemption phase of the M&A transaction.

Second, such provisions reduce the downside risk to the subject acquirer. That is, if the financial performance goals or other contract provisions are not met, subsequent payments are not made. That means that the total consideration ultimately paid by the subject acquirer to the seller is less than it would have been if the acquisition was more successful.

There are two drawbacks associated with the use of contract provisions that continue the involvement of the seller and/or key employees in the target company.

First, the use of such contract provisions adds a degree of complexity to the M&A transaction. Obviously (and intentionally), the seller is not completely removed from the target entity at the time of the closing. Therefore, the acquirer may not (1) obtain absolute control of the target entity or (2) be rid of all obligations to the seller until the conclusion of the earn-out or other contract provisions.

Second, in the case of a successful acquisition, the acquirer may have to make substantial post-closing payments to the seller. This may increase the total consideration paid for the target entity, when compared to an all-cash-at-closing price.

Nonetheless, the larger total consideration does not mean that the acquirer paid too much to the seller. This is because the subsequent payments are not made unless the target entity exceeds its financial projections or other stated benchmarks.

Financial Adviser Procedure 7—Incentivize Target Company Employees with Contracts Containing Performance Incentives, Stock Options, or Direct Equity Investments

The objective of this incentive compensation is to motivate target company management to (1) remain with the acquirer after the acquisition and (2) implement the acquirer's goals. The attitude of the target company management is often one of the most important elements in the success of the acquisition.

Target company management personnel who are committed to finding new jobs at new companies will not be dedicated to ensuring that the acquirer achieve the maximum return on its investment. Alternatively, target company management personnel who are appropriately motivated and compensated will work assiduously to make the subject acquisition a financial/operational success.

There are numerous compensation methods that are available to (1) encourage target entity management/physicians to stay and (2) motivate target company managements to internalize the acquirer's financial goals. These methods include:

1. stock and/or cash bonus plans,
2. incentive stock option plans,
3. plans that allow management to retain/obtain direct ownership of equity securities,
4. plans that compensate management with indirect ownership of synthetic equity securities, and
5. others.

All of these plans have a common attribute—the target company management income and/or wealth increases if:

1. the target company achieves predetermined post-acquisition benchmarks or
2. the acquisition is deemed successful by reference to some other predetermined goals or benchmarks.

In short, the greater return the acquirer earns on the acquisition, the greater the return the target company management earn on the acquisition.

As with any incentive procedure, there are drawbacks to the acquirer from such special acquisition-related compensation plans. If the acquisition is successful, target company executives may earn much more in the short term than the apparent market-level compensation amounts. However, these drawbacks can be mitigated by:

1. managing the acquirer's expectations and
2. effective communication.

It is true that target company managers may be highly compensated in the first few years following the transaction. However, they must earn that compensation by achieving predetermined goals. And, if the predetermined goals are established appropriately, that will increase the long-term value to the acquirer.

Therefore, even if the target company executives appear to be earning compensation levels above market-derived indications, that does not mean that they are being overpaid. This is because they had to earn their compensation by achieving predetermined, post-acquisition goals.

Procedure 8—Make Your Final Offer the *Final Offer*

There is typically a great deal of negotiation that occurs during the target company acquisition process. This includes negotiation over both the price and the structure of the deal. And, that's just the beginning. After the price and structure are agreed to in principal, considerable negotiation occurs with regard to each of the terms and conditions of the asset or stock purchase agreement. However, this recommended procedure relates to the deal pricing negotiation.

After (1) the financial adviser has performed the target company valuation analyses and (2) the acquirer company directors and selling parties have participated in several iterations of price negotiations, one best and final offer should be submitted to the target entity. The seller should understand that this is the final offer.

The price negotiation process has been completed. If the seller accepts the acquirer's final offer, the transaction will be consummated. If the seller rejects the acquirer's final offer, then the acquisition transaction will be terminated. No additional transaction price negotiations will take place.

The acquirer company directors will have offered the highest fair market value price it is willing to pay in this best and final offer. If the offer is accepted, the acquirer will not pay too much. However, the acquirer company directors should be disciplined to ensure that the acquirer does not exceed its "final" offer in a succeeding round of transaction negotiations.

Financial Adviser Procedure 9—Be Prepared to Walk Away from the Transaction if the Seller Does Not Accept the Final Offer

Of course, this procedure relates to recommended financial adviser procedure 8. If the seller does not accept the best and final offer, the acquirer should be prepared to withdraw from the negotiations. The acquirer company management may be disappointed in that outcome. This is because a great deal of time and effort was expended on the negotiations.

However, continued negotiation after the rejection of a final offer (1) causes the acquirer to lose credibility as a negotiator and (2) almost ensures that the acquirer will ultimately pay too much for the acquisition target.

If the final offer is not accepted, the acquirer should discontinue negotiations. The continued pursuit of the current transaction will likely result in an imprudent investment decision. After the negotiations are terminated, the acquirer should still accept communications from the seller. After all, the seller may ultimately accept the acquirer's final offer, after a period of reconsideration.

Financial Adviser Procedure 10—Obtain an Independent Assessment of the Deal Price/Structure Before Committing to the Transaction

This procedure involves retaining (and listening to) the professional advice of the independent financial adviser. This independent assessment results in a formal fairness opinion. However, in addition to a formal fairness opinion, the independent financial adviser can provide informed, objective advice to the target company directors regarding the transaction price parameters.

Of course, the financial adviser trusted with this important task should be independent of the subject transaction. In other words, this financial adviser is not one of the investment bankers who brought the deal to the seller or to the acquirer. Those financial intermediaries will likely be compensated based on a percentage of the ultimate transaction price. Accordingly, they are primarily motivated to have a transaction close because they want to avoid their performance fees.

Rather, what the acquirer needs at this point in the negotiation process is totally unbiased, objective, independent advice. This financial adviser should not have any economic disincentive to tell the acquirer directors "the price is getting too high; you should call the deal off."

SUMMARY AND CONCLUSION

It is fairly easy to identify situations after the fact where industrial and commercial company acquirers overpaid for acquisitions. It is also fairly easy with hindsight to specify the criteria that determine when an industrial and commercial acquirer paid too much in an M&A transaction. These criteria have been adequately discussed in the literature. However, what is important to acquirer company directors and to financial advisers is to establish procedures that minimize the probability of paying too much for the next target company acquisition.

This discussion presented 10 relatively simple procedures to assist transaction financial advisers to avoid overpricing in target company acquisitions. This list of procedures is not comprehensive. There are certainly other procedures that acquirer company directors may consider to help avoid overpaying in acquisition situations.

And, even these procedures will not ensure that a particular acquirer will not overpay for a particular target company acquisition. However, these procedures will generally assist transactional financial advisers from getting caught in the acquisition overpricing trap.

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Willamette Management Associates

Independent Financial Advisory Services

In today's litigious environment, boards of directors, independent transaction committees, shareholder groups, investors, and other corporate fiduciaries are concerned with demonstrating competent corporate governance and defending challenges related to business judgment, conflicts of interest, and dissenting shareholder/shareholder rights/shareholder oppression.

Willamette Management Associates has provided financial advisory services and rendered financial opinions in transactions with an aggregate value exceeding \$10 billion, spanning virtually every type of corporate transaction, including:

- mergers
- acquisitions
- going private transactions
- reorganizations
- divestitures
- financings
- restructurings
- joint ventures
- private placements
- asset/equity allocations

Our independent financial advisory services and transaction opinion services include:

- fairness opinions
- solvency/insolvency opinions
- adequate consideration opinions
- fraudulent conveyance opinions
- equity allocation opinions
- fiduciary alternatives opinions

Clients rely on our transaction opinion to avoid the conflict of interest inherent in a financial opinion from a party with a vested interest in the subject transaction. We provide independent transactional analyses and opinions. Our fees are service-based and are not contingent on the transaction completion.

We support our financial advice and transaction opinions with rigorous, comprehensive, and well-reasoned analyses. We provide post-deal audit support, litigation support, and expert testimony services, when needed.

Willamette Management Associates is a premier professional services firm specializing in financial advisory services and transaction opinions, business and intangible asset valuations, forensic accounting, transaction due diligence, and lost profits/economic damages litigation analysis. With offices in principal cities, we serve clients nationwide. Our corporate finance clients range from substantial closely held companies to multinational publicly traded corporations and include the transaction participant's legal, accounting, and banking advisers.

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VALUATION ADJUSTMENTS IN A FINANCIAL ADVISER TRANSACTIONAL ANALYSIS

Robert F. Reilly

Systematic and nonsystematic valuation adjustments can be either decremental (called valuation discounts) or incremental (called valuation premiums). Systematic adjustments are discounts or premiums that affect business and security valuations across the board—such as level of value adjustments. Nonsystematic adjustments are discounts or premiums that relate to a specific company or security—such as key customer dependence or buy/sell agreement transferability restrictions. This discussion explains the common procedures for identifying the factors or conditions that indicate the need for a nonsystematic valuation adjustment. This discussion explains the common procedures for quantifying nonsystematic valuation adjustments. This article includes several simplified illustrative examples. Finally, this article considers the appropriate sequencing of nonsystematic valuation adjustments.

INTRODUCTION

The application of valuation adjustments is common in business/professional practice valuations performed for fairness opinion, solvency opinion, or transactional fair market value opinions. In addition to valuations performed for merger and acquisition (M&A) transaction pricing and structuring purposes, such business/security valuations are also performed for purposes of (1) buy/sell agreements and private ownership transition, (2) financing collateral and securitization, (3) bankruptcy and reorganization, (4) taxation planning and compliance, (5) financial accounting and public reporting, (6) litigation support and dispute resolution, (7) management information and strategic planning, and (8) ESOP formation, financing, transactions, and regulatory compliance.

Valuation adjustments can be either discounts (decremental adjustments) or premiums (incremental adjustments). There are “level of value” valuation adjustments that analysts routinely consider in many transactional valuation assignments. These level of value adjustments include: (1) the degree of control or lack of control and (2) the degree of marketability or lack of marketability of the subject business or practice.

Consideration of level of value adjustments is a common analytical procedure in a business or security valuation. This is because the different valuation approaches and methods typically conclude different levels of value. These types of valuation adjustments are called systematic adjustments. Systematic valuation adjustments typi-

cally apply across various industries and across various company types and sizes. The application of systematic valuation adjustments is influenced by:

1. the legal/economic characteristics of the subject stock (e.g., does the subject stock represent target company operational/ownership control or not?);
2. the selected standard of value (e.g., fair market value, fair value, investment value, etc.); and
3. the selected premise of value (e.g., what premise of value represents the highest and best use of the target business or stock?).

This discussion summarizes these systematic (or level of value) adjustments in order to contrast them with nonsystematic valuation adjustments. This discussion primarily focuses on nonsystematic valuation adjustments. As the name implies, these valuation adjustments do not apply across the board to all business interests of the same level of value. While nonsystematic adjustments should be considered in all transactional business/security valuations, they are typically applied less often.

CATEGORIES OF NONSYSTEMATIC ADJUSTMENTS

Nonsystematic valuation adjustments typically fall into the following four categories:

1. company-specific adjustments,
2. security-specific adjustments,
3. contract-imposed adjustments, and
4. multitier adjustments.

These four categories will be described in greater detail later in this discussion. As an introduction, these adjustments relate to some factors that are specific to the individual valuation subject (i.e., the target block of stock) that would cause the analyst to apply a valuation discount or premium.

An example of a company-specific adjustment may be key customer dependence. Let's assume that 90 percent of the target industrial/commercial company revenue comes from one retail chain customer.

An example of a security-specific adjustment may be supervoting rights. Let's assume the target valuation subject is class B common stock that enjoys 100 votes per share, compared to the one vote per share enjoyed by the corporation class A common stock.

An example of a contract-imposed adjustment may be if the stock is subject to a mandatory shareholder agreement. Let's assume that agreement allows the target company to call the subject stock at any time at a call price equal to accounting net book value.

An example of a multitier adjustment may be a family limited partnership (FLP) interest that owns the remaining nonmarketable, noncontrolling stock of a closely held corporation. An analyst may apply a multitier adjustment when the corporation owns a substantial amount of liquid assets but neither (1) the subject FLP interest nor (2) the subject closely held stock interest has the right to demand an income distribution or asset liquidation.

These illustrative nonsystematic valuation adjustments do not relate to the level of value of the subject stock/transaction. And, these illustrative adjustments do not apply across a broad range of valuation subjects. Rather, the application of nonsystematic valuation adjustments is specific to the facts and circumstances of each individual transaction subject.

In contrast, while the quantification of nonsystematic adjustments is unique to each individual valuation subject, systematic valuation discounts and premiums are common across a broad range of transaction subjects.

This discussion concludes with a summary of caveats regarding the identification and quantification of nonsystematic valuation adjustments in business and stock valuation analyses. However, it is noteworthy to mention a few general caveats regarding valuation adjustments. Financial advisers should consider these general caveats with regard to a business or security valuation prepared for either transactional or notational purposes.

GENERAL CAVEATS REGARDING TRANSACTIONAL VALUATION ADJUSTMENTS

Adjustments Made to Conclude Value

First, both systematic and nonsystematic adjustments, are always made to reach a conclusion of value. Adjustments are not made from a conclusion of value. Inexperienced valuation analysts are often confused by this important distinction. They believe that the analyst first reaches a conclusion of the correct value for the subject business interest. Then, the analyst applies a discount or premium to the concluded value in order to arrive at a discounted value—or an inflated value.

This misconception is both procedurally and conceptually incorrect. In fact, analysts apply valuation methods to conclude value indications. Each business/security valuation method involves numerous analytical procedures. The various methods provide preliminary indications of value—until all of the requisite procedures are performed. And, one of the requisite procedures in all business valuation methods is to consider (and apply, when appropriate) valuation discounts and premiums.

So, valuation adjustments are applied to a preliminary value indication to arrive at a final value conclusion. Valuation adjustments are not applied to a final value conclusion to arrive at either a discounted or an inflated value conclusion.

Implicit Versus Explicit Adjustments

Second, regarding both systematic and nonsystematic adjustments, the application of adjustments—and the magnitude of adjustments—may vary by valuation approach and method. And, there are two components to this caveat: (1) implicit level of value, systematic adjustments and (2) implicit/explicit quantification of nonsystematic adjustments.

Some valuation approaches and methods typically conclude a certain level of value. The market approach/guideline publicly traded company method concludes a marketable, noncontrolling ownership interest level of value. Typically, the asset-based approach/asset accumulation method concludes a marketable, controlling ownership interest level of value. Typically, the income approach/discounted cash flow method can conclude either a controlling or a noncontrolling ownership interest level of value; the concluded level of value depends on the individual valuation variables selected for both (1) the cash flow projection and (2) the present value discount rate.

In each of these instances, the application of a systematic, level of value adjustment will depend on both (1) the level of value typically concluded by the selected method and (2) the individual valuation variables used in the specific analysis of that method.

Therefore, within the same financial adviser transactional assignment, systematic adjustments may apply to some valuation methods and not to others. And, depending on the individual variables used within the method, different magnitudes of the same valuation adjustment (e.g., discount for lack of marketability) may apply between the different valuation methods used in the analysis.

Regarding nonsystematic valuation adjustments, sometimes the financial adviser may make an adjustment implicitly within an individual valuation method analysis. And, sometimes, the financial adviser may apply an explicit adjustment to the value indication concluded by the individual valuation method.

For example, let's consider a discount for key person dependence. The key person could be the chief executive, chief salesperson, chief design engineer, or any other senior—and strategically important—executive. If the financial adviser uses the income approach/discounted cash flow method, the analyst could quantify a key person dependence discount either implicitly or explicitly.

Implicitly, the financial adviser could adjust the cash flow projection for the cost to recruit, hire, train, and maintain a hypothetical replacement executive (e.g., a first lieutenant for the key executive).

Explicitly, the financial adviser could conclude an unaffected preliminary business enterprise value indication—and then subtract either a discrete percentage discount or a discrete dollar discount (for key person dependence) from the preliminary value indication.

As another example, let's consider a discount for lack of voting rights in the valuation of the class B nonvoting common stock (e.g., a class of stock retained by the founding family). Again, the financial adviser may quantify this valuation adjustment either implicitly or explicitly.

If the financial adviser uses the market approach/guideline publicly traded company method, the valuation adjustment could be made within the analytical procedures—to conclude an implicitly discounted value indication. Or, the valuation procedures could be performed on unaffected basis, and the preliminary value indication could be explicitly adjusted for the discount.

Implicitly, the financial adviser could select only guideline company nonvoting stocks from which to extract market-derived valuation pricing multiples. The application of such pricing multiples would conclude a final value indication that is implicitly affected by a lack of voting rights.

Alternatively, the financial adviser could select voting guideline company stocks from which to extract market-derived valuation pricing multiples. The application of such pricing multiples would conclude a preliminary value indication that would need to be explicitly adjusted by a percentage discount for lack of voting rights.

Standard of Value Influences

Third, regarding both systematic and nonsystematic adjustments, the application of adjustments is directly affected by the standard (or definition) of value sought in the financial adviser transactional assignment. If the assignment standard of value is fair market value, then most valuation adjustments will typically apply. This is because the marketplace of willing buyers and willing sellers will generally recognize all valuation discounts and premiums.

However, if the assignment standard of value is fair value (as in a statutory dissenting shareholder rights case or a shareholder oppression case), then certain systematic, level of value adjustments may not be considered. In many situations (by statute or by judicial precedent), fair value is synonymous with pro rata business enterprise value (BEV). This pro rata business enterprise analysis concludes a value that is legally “fair” to all parties to the subject litigation.

That is, business enterprise value is the level of value where all shares of stock in the subject company have the same value per share. This is true regardless of whether the shares are owned by a 90 percent controlling stockholder or by a 10 percent noncontrolling stockholder. At the business enterprise level of value, the one stockholder receives no economic reward for squeezing out or oppressing another stockholder.

For example, under this interpretation of fair value, the controlling stockholder is not allowed to pay a “discounted” price of \$10 per share to the noncontrolling stockholder for shares that are worth \$20 per share to that controlling stockholder.

Therefore, in many fair value assignments, certain valuation adjustments are legally not applicable—even if the subject block of stock is a nonmarketable, noncontrolling ownership interest. The valuation principles that support this level of value in a fair value analysis are often called “the economics of fairness.”

Similarly, let's consider the example of an investment value (or owner value) assignment. In such an assignment, the financial adviser may not apply a nonsystematic discount for a suboptimal product distribution function at the subject company. If the current corporate owner wants to quantify the value to itself (given its specific corporate investment criteria) of a certain subsidiary, a discount for the lack of a distribution function may not be relevant. Let's assume that the corporate parent is a company like Pfizer, i.e., a pharmaceutical company that is recognized for its world class product distribution function.

Let's assume that the current corporate parent operates the subject company as a manufacturing subsidiary that effectively sells all of its production to a market/distribution subsidiary. For an investment value analysis, the lack of the subject company's distribution system would not represent a value penalty to the current owner. Therefore, the analyst

may not apply a nonsystematic lack of distribution function discount in an investment value analysis for a Pfizer-like corporate owner.

As another example, let's assume an acquisition value transactional assignment for a corporate acquirer. Let's assume the subject target company clearly suffers from key person dependence. The target company founder is a key person who will retire at the time that the company is sold. The potential acquirer is a large, publicly traded corporation that has several tiers of mid-level executives who are qualified to (and waiting for the opportunity to) manage a company the size of the target company.

The acquisition value standard of value indicates what a specific buyer would be willing to pay to a specific seller for the subject business interest. Given (1) the acquisition value standard of value and (2) the fact that the target's key person dependence does not represent a deficiency to the specific corporate acquirer, the financial adviser may decide not to apply a nonsystematic key person dependence discount in the acquisition value assignment for this particular acquirer.

NONSYSTEMATIC VALUATION ADJUSTMENTS

Something that is nonsystematic is not orderly, regular, or consistent. Nonsystematic valuation adjustments are discounts or premiums that may be considered—but are typically not applied—in all business/security valuations. Rather, they are specific to the individual facts and circumstances of a particular valuation target business/security.

Nonsystematic valuation adjustments generally are grouped into the following four categories:

1. company-specific,
2. security-specific,
3. contract-specific, and
4. multitier.

Each of the four categories is discussed below.

Company-Specific Adjustments

Company-specific valuation adjustments relate to facts and circumstances that are specific to the subject business/security. Common examples of company-specific valuation adjustments include:

1. discount for key person dependence,
2. discount for key customer dependence,
3. discount for key supplier dependence,
4. discount for key product/technology dependence,

5. discount for suboptimal capital structure, and
6. discount for suboptimal cost of capital.

These company-specific valuation factors can be either controllable or noncontrollable. For example, the subject company management may decide to employ a 100 percent equity capital structure because of its aversion to financial risk. However, that is usually a controllable decision.

On the other hand, there may be only one domestic supplier for the company's key medicinal chemicals component. In that case, management's reliance on the key supplier is an example of an uncontrollable decision.

In any event, all of these factors first affect the valuation at the business enterprise level. These factors are not related to the level of value of the subject ownership interest. And, these factors typically do not affect one class of company security differently than another class of company security.

Each of the factors in this category makes the subject company different (from an investment risk and/or expected return perspective) from the typical company in the subject industry or peer group. Accordingly, this category of valuation adjustment is typically made at the company (invested capital or total equity) level.

Security-Specific Adjustments

Security-specific valuation adjustments relate to facts and circumstances that are specific to the subject security interest or block of stock. Common examples of security-specific valuation adjustments include:

1. discount for lack of voting rights,
2. premium for supervoting rights,
3. blockage discount, and
4. discount for lack of preemptive rights.

All of these factors first affect the transactional valuation at either (1) the class of security level (e.g., a discount for lack of voting rights may be applied to all of the nonvoting common stock) or (2) the specific subject security level (e.g., a blockage discount may be applied to a 25 percent block of stock in an inactively traded public company).

And, each of the factors in this category makes the subject security interest different (from an investment risk and/or expected return perspective) from either (1) the typical security in the subject company or (2) a guideline or benchmark security used for comparative pricing purposes.

In any event, this category of valuation adjustment is typically applied at the subject security level (e.g., at the per share of stock level) and not at the business enterprise level.

Contract-Specific Adjustments

Contract-specific valuation adjustments relate to facts and circumstances that are imposed on the subject security by the influences of a contract, agreement, regulation, or covenant. Common examples of contract-specific valuation adjustments include:

1. stock subject to the buy-sell provisions of a shareholder agreement;
2. restricted publicly traded stock;
3. founder, letter, or other unlisted stock of a listed company; and
4. partnership units subject to a partnership agreement and limited liability company (LLC) units subject to an LLC agreement.

All of these factors affect the valuation of the specific subject ownership interest as the result of an exogenous influence. That exogenous influence is the result of a particular ownership interest being subject to the terms and conditions of some type of contract or agreement. This is often the case with stock owned by a private equity investor.

The contract terms may involve put, call, transfer, or ownership restrictions of a stockholder, LLC, or family limited partnership (FLP) agreement. The contract terms may affect the income distribution or asset liquidation proceeds rights of the subject ownership interest. In some cases, the contract terms may positively enhance the transferability of the subject ownership interest—such as the put option on ESOP-owned common stock that is a contractual condition of most ESOP trust agreements.

The exogenous influence may be the result of an employment agreement. Such an employment agreement may prohibit an executive from selling the subject stock (1) while he or she remains an employee or (2) for a specified number of years.

The exogenous influence may be the result of (1) an agreement with security underwriters or (2) a requirement of the Securities Exchange Commission (SEC) or an individual stock exchange. Unlisted shares of stock of a publicly traded company (e.g., founder stock, letter or legend stock, or stock subject to SEC Rule 144) are subject to contractual and/or regulatory transferability restrictions.

Each of the factors in this category makes the subject ownership interest different (from an investment risk and/or expected return perspective) from either (1) the typical security of the subject company that is not subject to the contractual/regulatory influence or (2) a guideline or benchmark security used for comparative pricing purposes.

In any event, this category of valuation adjustment is typically applied at the subject ownership interest level (e.g., the particular block of stock or other equity units).

Multitier Adjustments

Multitier valuation adjustments relate to facts and circumstances that are specific to the ownership structure of the subject security interest. Common examples of multitier valuation adjustments include:

1. closely held corporation (CHC) stock owned by an FLP,
2. nonconsolidated CHC stock owned by CHC,
3. any multitier ownership where a distribution will trigger the recognition of capital gains, and
4. a fractional or partial property ownership interest inside a CHC or FLP.

Multitier valuation adjustments are sometimes referred to as inside/outside valuation adjustments. In the typical instance, asset A is owned by asset B, which may itself be owned by asset C. Asset C is the valuation subject. Typically, in order to receive income distributions, the owner of asset C must first liquidate assets A and B. Accordingly, there is a series of security-specific and/or contract-specific adjustments that should be applied in the multitier ownership interest valuation.

In multitier ownership interest valuations, questions arise not only as to the magnitude of the appropriate valuation adjustments. Questions also arise as to the sequencing (and relative magnitude) of the appropriate valuation adjustments.

Typically, the lower level/inside adjustments are applied first, and the higher level/outside adjustments are applied second. That is, adjustments are applied to asset A, and an asset A cash equivalency value is estimated. Then, adjustments are applied to asset B, and an asset B cash equivalency value is estimated. Finally, adjustments are applied to asset C, and an asset C value is concluded.

SYSTEMATIC VALUATION ADJUSTMENTS

Systematic events affect a broad population and occur with regularity and order. This statement is also true of systematic valuation adjustments. They affect a broad range of valuation assignments. And, the analyst's application of systematic valuation adjustments occurs with great regularity.

In fact, depending on the valuation methods used, virtually all CHC business/security valuations involve either implicit or explicit systematic valuation adjustments. Accordingly, the financial adviser should consider the appropriateness of systematic valuation adjustments in virtually all valuations.

Although the category of systematic adjustments is not limited to level of value adjustments, these adjustments are the most common type of systematic adjustments. There

are two reasons for this. First, virtually every business/security valuation assignment involves a specified level of value. And, second, alternative valuation methods typically produce value indications at different levels of value.

Therefore, if the analysis involves two or more valuation methods, the financial adviser will typically have to apply some systematic adjustment in order to conform all of the value indications to the same level of value. All value indications should be stated on the same level of value (typically, the level of value consistent with the valuation assignment) before a meaningful valuation synthesis and conclusion is reached.

The most common systematic valuation adjustments include:

1. discount for lack of marketability (related to any ownership interest less than an overall business enterprise),
2. discount for illiquidity (related to the analysis of the overall closely held business enterprise),
3. discount for lack of ownership/operational control,
4. premium for ownership/operational control, and
5. premium for strategic/synergistic benefits.

The above-listed common systematic adjustments relate to the level of value of the subject ownership interest. Many inexperienced financial advisers believe that there are only three or four discrete levels of value. In fact, there is a virtually continuous spectrum of levels of value. And, the spectrum itself typically has two axes: (1) ownership control elements and (2) marketability elements.

There is a broad spectrum of value influences ranging from (1) absolute ownership/operational control with immediate synergistic opportunities to (2) absolute lack of ownership/operational control.

For example, an owner of a 30 percent block of CHC stock may have significant elements of operational control if there are 70 other unrelated stockholders, each of whom owns only one percent of the CHC stock. As another example, the owner of a two percent block of CHC stock can experience the swing vote value influences of control if there are two other unrelated stockholders, each of whom own 49 percent of the CHC stock.

The owner of 51 percent of a CHC stock has one level of ownership control. The value of that block of stock would likely deserve some level of control premium. However, in many states, a two-thirds vote is legally required for many corporate "control events" (e.g., a corporate liquidation or a sale of substantially all of the company assets). Therefore, the owner of a 67 percent block of stock may deserve a greater control premium than the owner of a 51 percent block of stock.

Likewise, the ownership of 80 percent of a company is required to consolidate a subsidiary for both financial accounting and income tax reporting purposes. That's why

many acquirers won't pursue a target company unless they are sure of buying at least 80 percent of the stock. Therefore, the owner of an 80 percent block of stock may deserve a greater control premium than the owner of a 79 percent block of stock.

The owner of a 95 percent block of CHC stock still has fiduciary obligations to the company's noncontrolling stockholders. The elimination of noncontrolling stockholders eliminates both this fiduciary duty and the possibility of nuisance litigation claims from dissenting stockholders. Therefore, the owner of a 100 percent block of CHC stock may deserve a greater control premium than the owner of a 95 percent block of stock.

There is also a continuing spectrum of value influences with regard to marketability elements. This broad spectrum of value influences ranges from:

1. absolute liquidity (equivalent to that enjoyed by actively traded stock listed on a public stock exchange) to
2. virtually absolute illiquidity (imposed by FLP, stockholder, buy/sell agreement, or by an other contract/agreement that restricts transfer, limits potential buyers, and dictates sale price).

The multitier ownership structure of the subject security (e.g., a security owned by an entity that is owned by another entity) may also have marketability implications that influence value.

While it may be impossible for financial advisers to conceptualize all of the discrete steps along the control/marketability continuum, these two elements really represent a continuous spectrum of combined valuation adjustment possibilities.

However, for visualization and illustrative purposes only, Figure 1 represents several of the common levels of value with regard to business/security valuation. Where applicable, Figure 1 also presents simplified indications of the valuation discount/premium relationships among the common levels of value.

Nonsystematic valuation discounts and premiums may be quantified as either (1) a percentage adjustment or (2) a dollar amount adjustment. When both percentage and dollar amount adjustments are appropriate, the financial adviser should carefully consider the appropriate sequence for applying the adjustments.

However, systematic valuation discounts and premiums (particularly level of value adjustments) are typically quantified as percentage adjustments. Therefore, if both control influence and marketability influence discounts/premiums are applied as percentage adjustments, then the mathematical sequencing of the application of systematic adjustments is often irrelevant. That is, as long as they are all expressed

on a percentage discount or premiums basis, the systematic valuation adjustments usually can be applied in any order.

WHY VALUATION ADJUSTMENTS ARE INTEGRAL TO THE VALUATION PROCESS

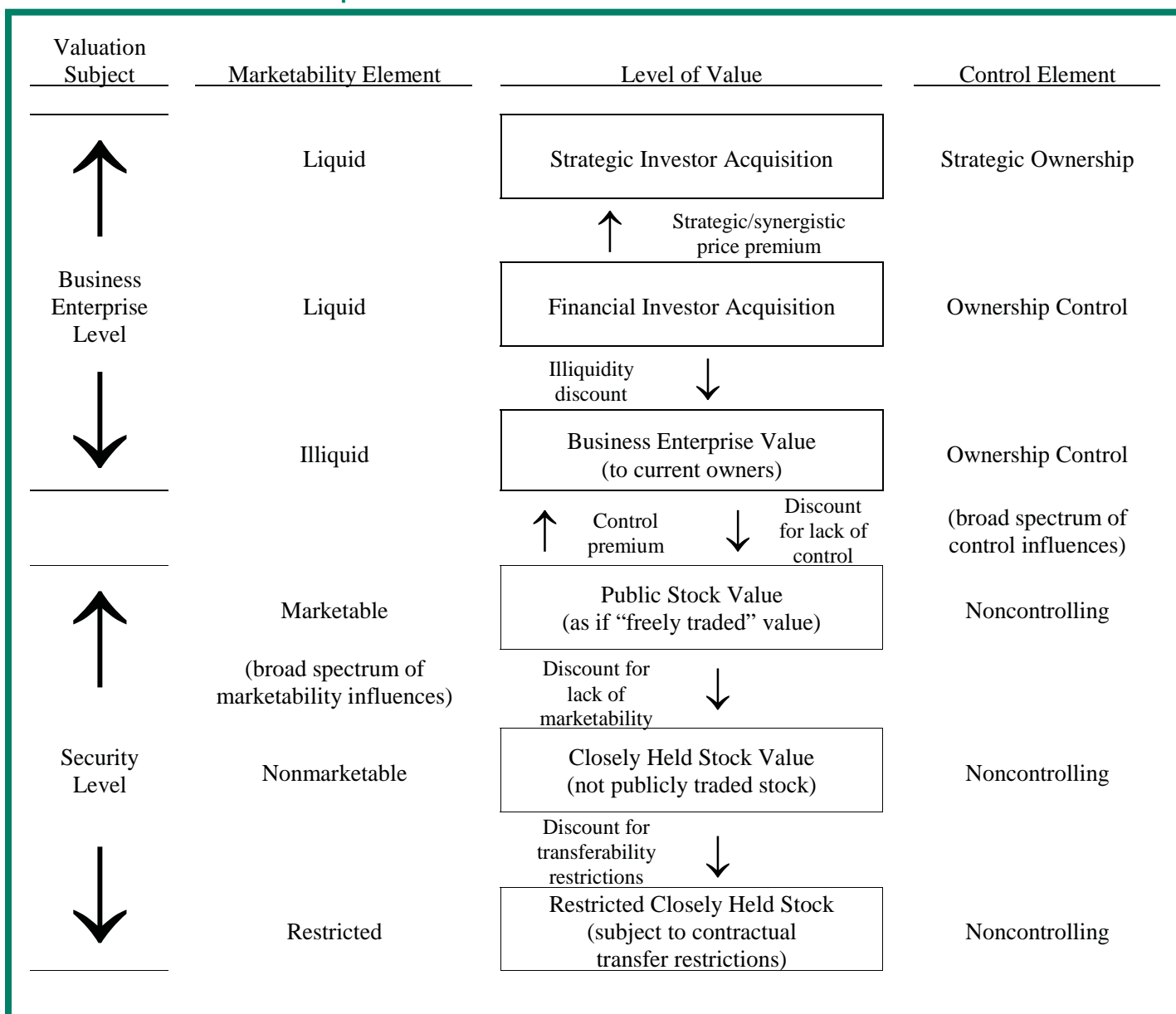
Experienced financial advisers understand that the concept of a valuation adjustment is meaningless without a clear answer to the question: adjustment to what? The financial adviser first has to understand the baseline or benchmark against which any valuation discount or premium is con-

templated. In other words, the application of any valuation discount or premium is fundamentally inappropriate unless the benchmark (against which the adjustment is compared) is clearly defined.

For example, it may be inappropriate to apply a discount for lack of marketability to a value indication that is already stated on a nonmarketable basis. Likewise, it may be inappropriate to apply an ownership control premium to a value indication that is already stated on a controlling ownership interest basis.

The first question for the financial adviser to ask with regard to a valuation adjustment is: What do I have? This

Figure 1
Business/Security Valuation Adjustments
Simplified Illustration of Common Levels of Value



question relates to what systematic and nonsystematic elements exist in:

1. the valuation approaches and methods selected,
2. the valuation variables used,
3. the guideline or other transactional data extracted, and
4. the valuation indications derived.

These elements (which either are present or are absent) represent the baseline or benchmark of the valuation analysis.

The second question for the financial adviser to ask with regard to a valuation adjustment is: What do I want? This question relates to what systematic and nonsystematic elements exist in (1) the subject company and/or (2) the subject security/ownership interest.

In particular, the financial adviser is looking for operational, financial, contractual, and regulatory features of the subject company/security that are different from those of the benchmark analysis. These selected features should make the subject company/security different from the benchmark analysis from an investment risk/expected return perspective.

It should be obvious why the financial adviser should thoroughly understand the benchmark analysis first. At this point in the valuation, the benchmark analysis is what the financial adviser has. Ideally, the benchmark analysis should perfectly match the subject company/security from an investment risk/expected return perspective. This is because an analysis of the subject company/security is what the financial adviser wants. If the elements in the benchmark analysis match up perfectly with the elements in the subject company/security, then no valuation adjustment is needed. Of course, that is rarely the case.

Therefore, the third question for the financial adviser to ask with regard to a valuation adjustment is: How is the subject company/security different from the benchmark analysis? When answering this question, the analyst identifies all of the systematic and nonsystematic elements in the subject that are not in the benchmark analysis—and vice versa.

Finally, the fourth question for the financial adviser to ask with regard to a valuation adjustment is: How do I get to what I want from what I have? In other words, what transactional adjustments are needed to make the value indications/ conclusions of the benchmark analysis more applicable to the valuation subject? Alternatively, what valuation adjustments are needed to minimize the systematic and nonsystematic element differences between the benchmark analysis and the valuation subject?

It is noteworthy that this fourth question helps the financial adviser identify valuation adjustments that make the investment risk/expected return features of the bench-

mark analysis look more like the valuation subject. It is not the objective of valuation adjustments to make the investment risk/expected return features of the subject company/security look more like the benchmark analysis.

In summary, valuation adjustments are only applicable to make the benchmark or baseline analysis look more like the subject company/security from an investment risk/expected return perspective. Therefore, it is important that the analyst fully understand the systematic and nonsystematic elements of the benchmark analysis before any valuation adjustments are considered.

In addition, the selection of the valuation adjustments is influenced by (1) the specific valuation approaches, methods, and procedures performed and (2) the purpose and objectives of the analysis, including the standard of value and the premise of value appropriate of the individual assignment.

ILLUSTRATIVE LISTING OF VALUATION ADJUSTMENTS

Table 1 presents a noncomprehensive listing of common valuation discounts and premiums. Table 1 does not distinguish between systematic (or level of value) adjustments and nonsystematic adjustments.

While Table 1 is not intended to be comprehensive, it may provide a convenient valuation adjustment checklist or reminder list for the financial adviser performing a business or security valuation.

METHODS TO QUANTIFY VALUATION ADJUSTMENTS

There are numerous analytical procedures that are used to quantify individual valuation adjustments. When considered conceptually, all of these individual procedures are grouped into four categories of methods:

1. comparative empirical data regarding the valuation subject,
2. comparative income data regarding the valuation subject,
3. published empirical data regarding valuation guidelines/benchmarks, and
4. reliance on judicial/administrative guidance.

Each of the four categories of methods is described below.

The first two above-listed methods use data extracted directly from the subject company/security. If such data are

Table 1
Business/Security Valuation Adjustments
Illustrative List of Common Valuation Discounts and Premiums

Valuation Discounts Related to:	Valuation Premiums Related to:
Assignee ownership interest	Ownership/operational control
Blockage (size) of public stock	Put options
Built-in capital gains taxes	Strategic/synergistic benefits
Call options	Superliquidation preference
Founder/letter/legend stock	Supervoting rights
Illiquidity (at business enterprise level)	
Key customer dependence	
Key person dependence	
Key supplier dependence	
Key technology dependence	
Lack of dividend rights	
Lack of marketability (at security level)	
Lack of ownership/operational control	
Lack of preemptive rights	
Lack of voting rights	
Multitier ownership structure	
Partial/fractional ownership interest	
Right of first refusal	
SEC Rule 144	
Suboptimal capital structure	
Suboptimal cost of capital	
Transferability restrictions (contractual)	
Unlisted stock of public company	

available, then these methods provide valuation adjustment indications that are specifically derived from the valuation subject.

In the first method, the financial adviser compares the valuation subject to a benchmark or baseline that does not have the discount/premium value influence. Based on this comparison, the financial adviser extracts pricing metric data that are used to quantify the specific valuation adjustment. In the second method, the financial adviser compares some measure of the valuation subject income to the same income measure, adjusted to exclude the effect of the valuation discount/premium. The capitalization of this income differential provides an indication of the appropriate amount of the valuation adjustment.

Using the comparative empirical data method, the financial adviser typically looks for comparative sales involving the subject security, where (1) one sale doesn't have the particular discount/premium feature and (2) the otherwise comparable sale does have the particular discount/premium feature.

For example, let's assume that there were historical sale transactions involving two classes of the company stock (one class with voting rights and one class without voting

rights). The financial adviser could examine these transactions and extract a discount for lack of voting rights.

Likewise, let's assume that there were historical sale transactions involving (1) stock subject to a right of first refusal and (2) otherwise comparable stock not subject to a right of first refusal. Again, the financial adviser could examine these transactions and extract a discount related to a contractual agreement right of first refusal.

Using the comparative income data method, the financial adviser typically identifies revenue, expense, or investment differences that are attributable to the particular discount/premium feature. The financial adviser attempts to quantify how the subject revenue, expenses, or investment would change if the particular discount/premium feature changes.

The financial adviser then capitalizes the expected income change over the remaining useful life (RUL) of the income change. The present value of the projected income difference provides an estimate of the amount of the valuation discount/premium.

For example, let's assume that Fred Founder is the controlling stockholder at Alpha Corporation, a CHC. As controlling stockholder, Fred Founder pays himself a salary

that is \$1 million per year greater than a reasonable salary level for a comparable executive at a comparable company. The financial adviser is attempting to quantify the ownership control premium associated with Founder's stock ownership interest.

The financial adviser could (1) isolate the economic benefit associated with the Founder ownership control (i.e., his excess compensation) and (2) capitalize that benefit at an appropriate capitalization rate. The capitalized excess compensation is one indication of the amount of the Founder ownership control premium.

All of the procedures related to the empirical data and the empirical income methods ultimately involve three types of analyses:

1. Estimate of the income shortfall related to the valuation discount; estimate of the income excess related to the valuation premium.
2. Estimate of the cost to cure the deficiency feature.
3. Paired sales analysis of (a) transactions with the subject discount/premium feature and (b) transactions without the subject discount/premium feature.

The empirical data and empirical income methods rely on income, cost, or sales data extracted from the subject company in order to quantify the systematic or nonsystematic valuation adjustment. The published empirical data method is the most commonly used method to quantify valuation discounts and premiums. Arguably, it is also the most commonly misused method.

Many financial advisers rely on published studies of empirical data to derive level of value adjustments, such as a discount for lack of marketability or a premium for ownership control. There are also numerous published studies with regard to nonsystematic valuation adjustments as well, such as a discount for lack of voting rights.

Most published empirical studies rely on the paired sales analysis procedure. These studies analyze (1) one set of sale transactions that are not affected by the subject feature and (2) one set of sale transactions that are affected by the subject feature. The percentage difference in transaction prices (or the percentage difference in transaction pricing multiples) provides an indication of the amount of the individual valuation discount or premium.

The difference in this third method (compared to the first two methods) is that both sides of the paired sales analysis comparison relate to guideline company/security transactions. In other words, none of the data analyzed in these published studies actually comes from the subject company/security.

This factor should not invalidate the use of this method however. The concern regarding the use of this valuation adjustment quantification method is not the data source.

The concern is how the financial adviser relies on the published study results to select subject-specific valuation adjustments.

Often, financial advisers rely on the more popular published empirical studies (1) without understanding the procedural mechanics of the published study, (2) without understanding the type (e.g., industry, size, etc.) of transactions analyzed in the published study, and (3) without considering the time period of the published study (compared to the subject valuation date).

In addition, financial advisers select the mean or median conclusion from the published study as the appropriate valuation discount or premium in every business/security valuation. When this happens, the resulting analysis has not reflected the range of results indicated by published studies—such as the interquartile conclusions, the standard deviations, and the high/low observations. And, the resulting analysis has not considered (qualitatively or quantitatively) exactly what valuation adjustment would be appropriate to the unique factors of the specific subject company/security—given the range of data reported in the published empirical study.

The fourth method for quantifying valuation adjustments relies on published judicial precedent and administrative rulings (e.g., Internal Revenue Service (IRS) audit settlement agreements) for guidance. While this method is sometimes used by inexperienced financial advisers, it is not recommended by experienced financial advisers.

This method does provide the financial adviser with very useful information as to the reasonable range of valuation discounts and premiums that courts and regulators have found acceptable. However, these data do not provide a particularly useful source of information from which to select a specific valuation adjustment related to a specific business valuation.

Judicial precedent, IRS letter rulings and settlement agreements, and other administrative rulings are always fact-specific. By definition, they only apply to the specific facts and circumstances of the matter and/or taxpayer to which they apply. They are not intended to provide general professional guidance with regard to the appropriate level of valuation discounts and premiums. Published judicial decisions (and other rulings) are only applicable to the extent that the subject company/security facts and circumstances are identical to the published decision facts and circumstances. And, that is hardly ever the case.

FINANCIAL ADVISER CAVEATS

Table 2 presents a nonexhaustive listing of 10 caveats that financial advisers should consider with regard to the identification and quantification of transactional valuation

discounts and premiums. These “top 10” caveats apply to all four methods for quantifying transactional valuation adjustments.

SUMMARY AND CONCLUSION

This discussion focused on the identification and quantification of nonsystematic and multitier valuation adjustments. This discussion also touched on the identification and quantification of systematic (e.g., level of value) valuation adjustments. This discussion considered both (1) when and (2) why valuation adjustments are applicable in the business and transactional valuation process. This discussion presented an illustrative (but nonexhaustive)

list of common business/security transactional valuation discounts and premiums.

In particular, this discussion presented (1) the four common methods for quantifying valuation adjustments and (2) the three common procedures for quantifying transactional valuation adjustments. Comparative conceptual/practical strengths and weaknesses of the various valuation adjustment methods were discussed. And, this discussion presented a nonexhaustive list of “top 10” caveats that financial advisers should consider when selecting specific business/security valuation discounts and premiums.

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Table 2
Business/Transaction Valuation Adjustments
"Top 10" List of Caveats Regarding Valuation Discounts and Premiums

1. Financial advisers should thoroughly understand the valuation analysis baseline or benchmark before applying any valuation adjustments.
2. Financial advisers should thoroughly understand the economic influences of the specific systematic or nonsystematic feature considered; does it actually affect the investment risk and/or expected return of the subject company/practice?
3. Financial advisers should be careful not to “double count” valuation adjustments. For example, a valuation discount for the built-in gains tax may be a component of an overall discount for lack of marketability—and not a separate, discrete valuation adjustment.
4. When financial advisers use alternative procedures to quantify valuation adjustments (e.g., income shortfall/excess, cost to cure, paired sales analysis), the lowest valuation adjustment indication is often the most appropriate valuation adjustment conclusion.
5. Financial advisers should not solely rely on published judicial precedent as the basis of selecting specific valuation adjustments, unless the facts and circumstances in the subject valuation are identical to those in the published decision.
6. Financial advisers should be aware that not all valuation methods/indications may be subject to the same valuation adjustment—or to the same magnitude (either dollar amount or percentage) of valuation adjustment.
7. Financial advisers should recognize that the application of valuation adjustments is influenced by the purpose and objective of the analysis (e.g., the assignment standard of value, premise of value, etc.) as well as by the specific features of the subject company/practice.
8. Financial advisers should be sufficiently familiar with the content and intent of published empirical valuation adjustment studies before relying on such published studies as the basis of selecting a specific valuation discount or premium.
9. Financial advisers should carefully consider the time period covered in any published empirical valuation adjustment study before relying on that published study for use as of a specific valuation date.
10. Financial advisers should carefully consider the dispersion of the results reported in published empirical valuation adjustment studies. Financial advisers should avoid the naive reliance on the mean or median results of such published studies without considering whether such conclusions are applicable to the specific facts and circumstances of the subject valuation.

Willamette Management Associates Insights

WHAT RECOGNIZED AUTHORITIES ARE SAYING ABOUT *THE HANDBOOK OF BUSINESS VALUATION AND INTELLECTUAL PROPERTY ANALYSIS*

*Robert F. Reilly and Robert P. Schweih*s

- As is usual with books by Reilly and Schweih, this 662 page book contains twenty four chapters that are well written, provide useful examples, and lend themselves to practical application.”
National Litigation Consultants’ Review, June 2005
- “*The Handbook of Business Valuation and Intellectual Property Analysis* provides practitioners with the latest information and knowledge on key aspects of business and intellectual property valuation, damages and transfer price analyses.”
ASA FastRead, February 15, 2005
- “What can be said about this book except that Robert Reilly & Robert Schweih have done it again. They have compiled a collection of explanatory works covering a wide array of specific issues that either have not been covered in previous publications or go into greater detail with updated information.”
Business Appraisal Practice, Spring 2005
- “This business handbook offers instruction and analyses on business valuation, damages, transfer price and intellectual property, helping professionals as well as beginners make effective decisions.”
Columbia Today, May 2005
- “CPAs who function as CFOs, treasurers and controllers will find the *Handbook* an important reference resource.”
The Business Edge, March 16, 2005
- “. . . the reader is provided with updated, clean, concise and comprehensive answers to the many questions related to business valuation.”
The Licensing Journal, January 2005
- “These experts explain, in very understandable terms, what the valuation process consists of.”
CPA Line Items, August/September 2004
- “. . . provides practitioners with the latest information on key aspects of business and intellectual property valuation, damages and transfer-price analyses.”
The Tax Adviser, March 2005
- “All in all *The Handbook of Business Valuation and Intellectual Property Analysis* is an indispensable addition to any valuation practitioner’s library.”
AICPA Business Valuation Web site, April 19, 2005
- “I recommend it to any serious valuation professional, as well as to those just entering the field.”
The CPA Journal, February 2005
- “Wondering what the experts are saying? Want the inside track on new legal precedents? Need a better understanding of intellectual property valuation? Then search no further than *The Handbook of Business Valuation and Intellectual Property Analysis*.”
Shannon Pratt’s Business Valuation Update, November 2004

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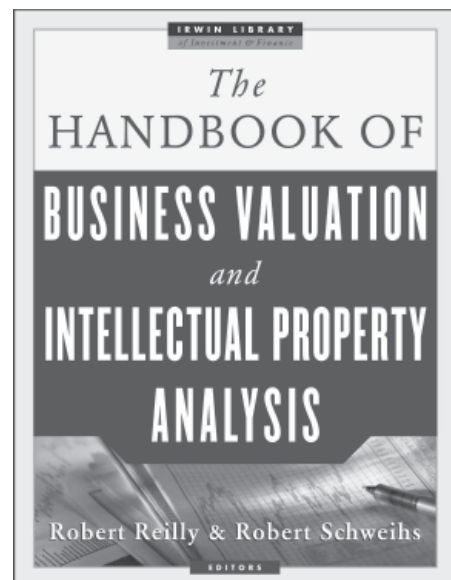
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Financial Advisory Services Insights

THE ROLE OF THE INDEPENDENT FINANCIAL ADVISER IN M&A TRANSACTION FAIRNESS OPINIONS

Robert P. Schweihs and Robert F. Reilly

Corporation boards of directors (not-for-profit institution trustees, securities lawyers, and other parties) typically request—and rely on—fairness opinions when evaluating merger and acquisition (M&A) transactions. Typically, however, these fairness opinions are issued by the same investment banker/financial intermediary who structured and priced the pending M&A transaction. This discussion contrasts the role of the deal financial intermediary with the role of the independent financial adviser with respect to the probity and objectivity of M&A transaction fairness opinions.

INTRODUCTION

About two years ago, *Business Week* published an article entitled “A Fair Deal—But for Whom?” That article reported on the function of fairness opinions in corporate merger and acquisition (M&A) transactions. That article also questioned whether investors, corporate directors, or even transaction participants can rely on a fairness opinion prepared by the same financial intermediary who structured the subject M&A transaction.

Since then, several business periodicals have questioned the ability of performance-compensated investment bankers to act as “independent” financial advisers with regard to deals they put together. Indeed, these publications have wondered how it would be possible for an investment banker (IB) to conclude that a deal he or she structured was not fair. In other words, would any IB not issue a fairness opinion on his or her very own transaction structure?

In this era of Sarbanes-Oxley corporate governance compliance, increased Securities and Exchange Commission scrutiny, and potential shareholder litigation, corporate directors (and their legal counsel) rely heavily on fairness opinions as evidence of their corporate stewardship regarding M&A transactions.

However, can corporate directors (or not-for-profit entity trustees) rely on a fairness opinion prepared by the IB who structured the pending transaction? Isn't such reliance on the transaction financial intermediary's fairness opinion like relying on the corporate accountant to audit the company's own financial statements? Just like no accountant can objectively audit his or her own

accounts, no financial intermediary can objectively opine on the fairness of his or her own transaction.

THE ROLE OF THE TRANSACTION FINANCIAL INTERMEDIARY VERSUS THE ROLE OF THE INDEPENDENT FINANCIAL ADVISER

Willamette Capital provides performance-based investment banking services to substantial privately owned companies. And, Willamette Management Associates provides independent financial advisory services (e.g., transactional fairness and solvency opinions) to both publicly traded and closely held corporations. However, seldom is it appropriate to perform both types of services for the same client on the same deal.

Willamette Capital provides the typical client-representation investment banking services. These performance-fee-based IB services include:

1. capital formation (including the private placement of debt and equity securities),
2. business brokerage (including M&A transaction negotiations), and
3. financial restructuring (including debt/equity reorganization, equity recapitalization, and troubled debt restructuring).

And, Willamette Management Associates provides the typical independent financial advisory services. However,

these services are not performance-fee based. These services include debt/equity security design and transactional opinions such as (1) fairness opinions, (2) solvency opinions, (3) adequate consideration opinions, and (4) fair market valuations. These transaction opinions relate to (1) corporate M&A, (2) ESOP formation and acquisition, (3) joint venture formation and dissolution, (4) not-for-profit institution excess benefit avoidance, and (5) secured lender (e.g., fraudulent conveyance avoidance) transactions.

Financial intermediaries typically perform IB services on a performance fee/commission basis. In these situations, the financial intermediary is not compensated if the transaction is not consummated. Accordingly, the IB financial intermediary has an economic incentive to structure a deal that will close—and not necessarily a deal that is theoretically fair from a financial perspective to any particular investor constituency.

Most importantly, the IB financial intermediary is not independent of the subject transaction. The IB is an agent of one of the M&A transaction principals; and the IB has a duty to that party only.

Independent financial adviser firms typically perform opinion and other transaction-related services on a fee-for-service basis. Accordingly, the independent financial adviser is not compensated based on a percentage of the transaction price.

In addition, the independent financial adviser is compensated for professional advice whether or not the subject transaction closes. Therefore, the independent financial adviser has no economic incentive to give a biased opinion—even if it means that opinion derails an “unfair” pending transaction.

In addition, the independent financial adviser has a duty to whomever the transaction opinion is addressed. The independent financial adviser analyzes the pending transaction from the perspective of the stated opinion audience—and not solely from the perspective of a particular transaction principal.

We believe that client representation financial intermediaries and independent financial advisers both have important—but separate—roles to play in M&A transactions. However, the two roles are almost always distinctly different. And, directors (and other parties with fiduciary duties) who rely on an IB financial intermediary with an economic interest in the subject deal should not expect to receive independent financial advice.

"TOP 10" FACTORS TO CONSIDER REGARDING FINANCIAL INTERMEDIARY FAIRNESS OPINIONS

The following "top 10" list indicates factors that investors, corporate directors, institutional trustees, securities law-

yers, securities industry regulators, and other interested parties should consider when relying on a fairness opinion issued by the IB financial intermediary who structured the subject M&A transaction.

This list of factors is not intended to be comprehensive. And, this list of factors is not presented in any particular order of importance.

Factor Number 1

Under the Sarbanes-Oxley Act, certified public accounting (CPA) firms can no longer provide certain services (e.g., appraisals and valuations) to their audit clients. This is because those services would involve the CPA firms auditing their own work. In another area of corporate governance, how can the financial intermediary IB “audit” (i.e., opine on the fairness of) his or her own M&A transaction work?

Factor Number 2

When a financial intermediary has the transaction performance fee (i.e., commission) at risk, can corporate directors or investors expect the IB to be totally objective and unbiased—to the extent of derailing the pending transaction by not issuing a favorable fairness opinion?

Factor Number 3

Let's ignore the economic influence associated with the pending transaction performance fees. The IB financial intermediary still has his or her professional pride and reputation invested in the particular transaction price/structure. Can corporate directors or investors expect the IB to be impartial enough to not issue a favorable fairness opinion on his or her own transaction price/structure?

Factor Number 4

In the post-SOX era more than ever, independent corporate directors (and institutional trustees) want—and need— independent advice. Post Sarbanes-Oxley, independent corporate directors regularly retain independent legal counsel and independent forensic accountants.

Clearly, the financial intermediary who structured the pending transaction cannot also serve as an “independent” financial adviser to independent corporate directors.

Factor Number 5

Let's ignore the IB financial intermediary independence issues regarding performance compensation and personal vested interest. An independent financial adviser can bring a fresh and different perspective to the assessment of the

pending transaction. This professional “fresh pair of eyes” should be welcome by all parties (and certainly by all principals) to the pending M&A transaction.

Factor Number 6

An independent financial adviser will likely use different deal valuation variables—for example, guideline publicly traded companies, guideline M&A transactions, income projections, and discount/capitalization rates—in his or her analysis of the pending transaction than the deal valuation variables used by the financial intermediary who put the transaction together. If the pending M&A transaction is financially sound, then this independent financial analysis should provide independent confirmation of the financial intermediary's selection of deal valuation variables.

Factor Number 7

An independent financial adviser will likely use different valuation approaches and methods in his or her analysis of the pending transaction. If the pending M&A transaction is financially sound, then the use of additional valuation approaches and methods should also provide independent confirmation of the financial intermediary's transaction price/structure conclusions.

Factor Number 8

An independent financial adviser will have a different “master” than the IB financial intermediary who sponsored the pending transaction. Although all fairness opinions are typically addressed to the corporation board of directors, the financial intermediary is typically retained by the company management. And, the IB financial intermediary has worked closely with the CEO, director of M&A, and other corporate executives who have a vested (financial or professional) interest in closing the pending transaction.

In contrast, an independent financial adviser retained by the corporation board would only serve the interests of the directors (and, through the directors, the interests of the stockholders).

Factor Number 9

The total deal transaction costs may actually be lower if (1) the IB financial intermediary structures the deal and (2) an independent financial adviser issues the fairness opinion. As a rule of thumb, an IB typically allocates about 20 percent of the total transaction fees to the preparation of a fairness opinion.

In contrast, independent financial advisers issue fairness opinions on a fixed fee basis (and not on a percent of the transaction price basis). Often, this fixed fee for the independent financial adviser's transaction opinion is less than 20 percent of the total IB fee (i.e., the fee amount that the corporation would not have to pay to the IB if the IB did not issue a fairness opinion).

Factor Number 10

Ultimately, corporate directors should ask themselves: how would I explain this decision to rely on the IB financial intermediary in a shareholder lawsuit deposition or trial cross examination? If the corporate directors are comfortable explaining why they relied on the performance fee compensated IB financial intermediary to opine on the subject transaction fairness, then they should elect that option.

On the other hand, if the corporate directors would be more comfortable explaining that they relied on a totally independent financial adviser to opine on the subject M&A transaction price/structure fairness, then they should elect that option.

"IB financial intermediaries . . . need independence—the same level of independence as an independent financial advisor."

SUMMARY AND CONCLUSION

Some business journals have suggested that a new set of professional/technical standards (something akin to generally accepted auditing standards) should be developed regarding the analysis for/reporting of M&A transaction fairness opinions. IB financial intermediaries would then be subject to these new standards when preparing their transaction fairness opinions.

However, IB financial intermediaries don't need new professional/technical standards to issue transaction fairness opinions. They simply need independence—the same level of independence as an independent financial adviser.

Some observers may suggest that independence rules regarding the issuance of M&A fairness opinions will lead to incestuous arrangements between IB financial intermediaries (i.e., I'll opine on your transaction if you opine on my transaction). Nonetheless, even the cross-referral of fairness opinion engagements among financial intermediaries would result in more independence—and more benefit to corporate directors and other transaction participants—than the current system of IBs “auditing” their own M&A transactions.

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Financial Advisory Services Insights

DIRECTORS & BOARDS INTERVIEW WITH BOB SCHWEIHS

In its May 2005 issue, the journal Directors & Boards, interviewed Willamette Management Associates managing director Robert P. Schweihs. Schweihs discussed the role of the independent financial adviser (particularly as it relates to reasonableness of executive compensation issues and to corporate governance issues) with Directors & Boards. The following is a reprint of the May 2005 Directors & Boards interview.

**Directors
& Boards**
THOUGHT LEADERSHIP
IN GOVERNANCE SINCE 1976



Robert P. Schweihs
Managing Director
Willamette Management Associates

Editor's note: Each month, we ask a Directors & Boards reader to comment on critical issues facing directors today. If you'd like to participate in this section in the future, please e-mail Scott Chase (scottchase@verizon.net).

There has been a lot written recently about the reasonableness of executive compensation. Why is this issue so high-profile, and is this issue primarily of concern only to public corporations?

One reason this issue is so high-profile is the publicity surrounding recent corporate scandals, including the perceived abusive compensation practices at many publicly traded companies. Shareholders are understandably concerned. In addition, the Internal Revenue Service (IRS) in recent years has aggressively challenged (1) the deductibility of "excessive" executive compensation for closely held C corporations and (2) the avoidance of payroll-related taxes by S corporations due to unreasonably low executive compensation.

There are many reasons why reasonableness of executive compensation is of concern to both public and privately held corporations. This is also an important topic to the boards of directors of not-for-profit organizations related to private inurement issues.

What are some of those reasons?

For a privately held corporation (either an S corporation or a C corporation), the reasonableness of executive compensation is of interest principally to the IRS. For the closely held S corporation, the IRS is typically concerned with whether shareholder/employees are paid an unreasonably low level of executive compensation. This is because unreasonably low levels of S corporation shareholder/employee compensation are not subject to FICA, Medicare, FUTA, SUTA, and other compensation-related employment taxes. Instead of being paid reasonable levels of compensation, S corporation shareholder/employees often "pay" themselves by taking periodic S corporation income distributions. Since these income distributions do not qualify as wages, they are not subject to the above-mentioned employment taxes.

For the closely held C corporation, the IRS is typically concerned with whether shareholder/employees are paid an excessive amount of executive compensation. The IRS is concerned with this compensation issue because:

1. reasonable amounts of compensation payment are a tax deductible expense of the C corporation, but
2. the excessive (or unreasonable) amounts of shareholder/employee compensation are often reclassified as nondeductible dividend payments.

How about for publicly traded corporations?

For a publicly traded corporation, however, the IRS has little interest in the reasonableness of the executive compensation paid. This is because the compensation payments made to public corporation executive officers are almost always taxable to the employees (ignoring timing issues), and the compensation payments made to public corporation executives are almost always deductible to the corporation (ignoring timing issues).

The IRS typically concludes that the executive officers of a public corporation cannot set their own compensation. This is typically true even if the executive is also a significant shareholder of the public corporation. This is because executive officers are ultimately responsible to the board of directors (and particularly to the board compensation committee) with regard to compensation matters. And, the public corporation board of directors is ultimately responsible to the shareholders. Therefore, unlike in a closely held corporation where shareholder/employees often determine their own compensation levels, there is typically an independent review of the reasonableness of executive compensation (by the board directly and by shareholders indirectly) in a public corporation.

It is the public company directors who should be interested in whether or not the compensation of the corporate officers is reasonable. Of course, the shareholders should also be concerned that executives do not receive unreasonable levels of compensation. Shareholders should be concerned from both a corporate governance perspective and an economic self-interest perspective.

Obviously, shareholders are concerned that unreasonably high executive compensation payments result (1) in a dissipation of corporate assets and (2) less cash being available to pay shareholder dividends. And, corporate directors are concerned that the executive compensation plan motivates executives to act in a manner consistent with the shareholders' long-term value appreciation objectives.

Lastly, not-for-profit institution directors are concerned that the IRS may conclude that their organization pays unreasonably high levels of executive compensation. The payment of excessive compensation to not-for-profit executives results in the private inurement of the organization's funds. At the extreme, the organization could risk having its not-for-profit tax status revoked. Accordingly, the directors of such organizations often want independent assurance that they are not authorizing the payment of unreasonable levels of executive compensation.

What can a board member do to assure that the compensation paid to its senior executives is reasonable?

To minimize (or defend against) allegations of unreasonable executive compensation, corporate directors often rely on an objective, independent financial adviser to perform a reasonableness of executive compensation analysis.

An independent reasonableness of executive compensation analysis can help directors of closely held corporations with income tax concerns. This analysis can assist not-for-profit organization directors with regard to IRS concerns of private inurement. And, an independent reasonableness of executive compensation opinion can assist directors of public corporations with shareholder harmony, corporate governance, and Sarbanes-Oxley compliance concerns.

Independent reasonableness of executive compensation analyses (and the resulting independent financial adviser opinions) can assist public corporation, private corporation, and not-for-profit organization directors fulfill their responsibilities with regard to corporate governance, income taxation, and private inurement issues.

Robert P. Schweih is managing director of Willamette Management Associates. Schweih is an accredited senior appraiser, certified in business valuation, of the American Society of Appraisers. He is also a certified business appraiser with The Institute of Business Appraisers, Inc. He is also a former Trustee of The Appraisal Foundation. He holds a bachelor of science degree from University of Notre Dame and a master of business administration degree from the University of Chicago Graduate School of Business.

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THE ROLE OF THE FINANCIAL ADVISER IN VALUING PHARMACEUTICAL INDUSTRY INTELLECTUAL PROPERTY

Robert P. Schweih and Michel M. St. Martin

Pharmaceutical industry products that are in the early stages of development present special valuation challenges. These early-stage ventures often have no product revenue to date and little or no operating expense history. These ventures usually involve an incomplete management team with an idea, plan, and some initial product development. Using a hypothetical new prescription drug, this article explains that the reason the rates of return that are required for such early-stage ventures appear high is because those required rates of return reflect the probability of—and cost of—failure.

INTRODUCTION

The commercial development of a new prescription drug is an extremely costly and highly risky endeavor. Estimating the value of the new prescription drug intellectual property is also a difficult task.

In a pharmaceutical industry product development effort, there are established stages of clinical trials. These clinical trial stages must be successfully completed before the new drug can be commercialized.

In this article, we use an example to compare (1) a multiple-stage, multiple-probability cash flow projection with (2) a life-cycle projection. It is important for analysts who are presented with a life-cycle projection for a new product to consider the probability of failure, especially during the early stages of a new product's development.

BACKGROUND

Recently, we were asked to estimate the value of a patent for a new drug compound. The purpose of the valuation was to negotiate the ownership percentage that the patent holder was to receive in exchange for contributing the patent rights to a joint venture. The joint venturer was a large pharmaceutical company. The valuation analysis we performed in this matter was similar to other pharmaceutical industry intellectual property valuations we have performed for purposes of corporate planning, estimating the value of in-process research and development, financial statement purchase price allocation, estimating collateral value, estimating asset values in a bankruptcy context, and estimating damages in a litigation context.

Our analysis work product differed for each of these engagements. That is because each engagement involved a different purpose, standard of value, premise of value, and stage of intellectual property development. However, in each analysis, we used some combination of the approaches, methods, and procedures described below.

THE PRESCRIPTION DRUG APPROVAL PROCESS

The process of new proprietary drug approval in the United States is one of the most rigorous processes in the world. Only a small percentage of compounds that enter the preclinical testing stage are ever approved for commercialization.

Clinical trials are typically conducted in three sequential phases. However, these three phases may overlap or be combined.

During the preclinical testing stage, laboratory and animal studies are conducted. These studies show the biological activity of a drug compound against the targeted disease. During this stage, the new drug compound is evaluated for safety.

After an Investigational New Drug Application (INDA) becomes effective, Phase 1 human clinical trials can begin. These trials, involving a small number of healthy volunteers or patients, usually define a drug candidate's safety profile, including the safe dosage range.

In Phase 2 clinical trials, controlled studies of volunteer human patients with the targeted disease are conducted. These studies are conducted to assess the drug's effectiveness. These studies are designed primarily (1) to

determine the appropriate dose levels, (2) to conclude dose schedules and route(s) of administration, (3) to evaluate the effectiveness of the drug on humans, and (4) to determine if there are any side effects on humans (which would cause the expansion of the safety profile following Phase 1).

Phase 3 usually involves large numbers of patients with the targeted disease. During the Phase 3 clinical trials, physicians monitor the patients (1) to determine the drug candidate's efficacy and (2) to observe and report any adverse reactions that may result from long-term use of the drug on a large, more widespread, patient population. During the Phase 3 clinical trials, the drug candidate is compared to either (1) a placebo or (2) a standard treatment for the target disease.

After completion of all three clinical trial phases, if the data indicate that the drug is safe and effective, a new drug application (NDA) is filed with the U.S. Food and Drug Administration (FDA).

If the FDA approves the NDA, (1) the new drug becomes available for physicians to prescribe to patients for treatment and (2) the new drug begins to generate revenue for its owner.

Sometimes the FDA offers conditional NDA approval subject to additional Phase 4 studies. Phase 4 studies are conducted (1) to explore additional patient populations; (2) to compare the drug to a competitor; or (3) to further study the risks, benefits and optimal use of the drug. The marketing of a drug after FDA approval is subject to substantial continuing regulation by the FDA. This regulation includes (1) adverse event reporting manufacturing practices and the advertising and promotions of the drug.

INTELLECTUAL PROPERTY VALUATION METHODOLOGY

As with all intellectual property, pharma intellectual property is valued by reference to the cost, market, and income valuation approaches. All three valuation approaches may be informative of intellectual property value, including the value of a new prescription drug. In this article, we focus on the income approach—and particularly the discounted cash flow method.

To apply the discounted cash flow (DCF) method, the analyst projects net cash flow for several discrete time periods into the future. The projection of cash flow is converted into a present value by the use of a present value discount rate. The discount rate represents the investor's required rate of return over the expected term of the cash flow projection. The length or duration of the discrete cash flow projection period—and whether or not a residual or terminal value should be considered at the conclusion of the discrete projection period—depends on the analyst's expectation of the duration of the new drug's cash flow stream.

PROJECTED PERFORMANCE

Typically, an analyst understands the projected performance of a new drug by reviewing projections provided by the inventors of the new drug. In this illustrative example, the investors are at the earliest stages of clinical trials. However, they have a protectable intellectual property interest (e.g., a patent), and they have targeted a certain commercial market segment. They have prepared a simple projection for this new drug. The projection is simple because it does not include any revenue during the clinical trial process that drug inventors sometimes enjoy for having achieved milestones. Also, the inventors have adopted an expected remaining useful life of 17 years for the drug that anticipates competition from other pharmaceutical companies, including generic drug manufacturers.

In this case, there is a significant probability that the proposed new drug will fail at the conclusion of each of the three clinical trial phases. If the new drug successfully completes the third phase of the clinical trials, there is a 90 percent chance that it will be granted FDA approval—six years from now. The new drug will be abandoned if it fails any of its tests. Once the new drug successfully completes each phase of the clinical trials, it proceeds to the next phase of the clinical trials—until it finally achieves FDA approval. At that point, the new drug becomes commercially available and generates revenue for the drug inventor. This decision tree process is illustrated in Table 1.

The current size of the total market in which this new drug will participate has been reliably estimated to be \$1 billion. And, the market will increase at the growth rate of three percent per year thereafter. If successfully developed, the proposed new drug is expected to achieve a certain share of that market. That market share is expected to peak at 40 percent eleven years from now and then, due to competitive forces, gradually decline. Concurrent with the clinical trials, the projection anticipates that the inventor of the new drug will be communicating with the FDA. Upon successful conclusion of the third phase of clinical trials, the inventor will receive FDA approval and will begin to generate revenue from the new drug.

To develop and commercialize the new drug, expenses will be incurred in the form of research and development (R&D) efforts, operating expense, and sales and administrative expense (see Table 2). Capital charges for net working capital and for associated tangible and intangible assets are also accounted for (see Table 3). Based on these projections, the successful new drug will generate cash flow of over \$195 million at a 12 percent present value discount rate. However, this new drug may not successfully pass all of its tests. Of the total of five scenarios that are possible outcomes, four are failures where significant operating losses will be suffered.

On a probability weighted basis, the value of the new prescription drug intellectual property is approximately \$12 million (see Table 4).

SENSITIVITY ANALYSIS

We established a range for several of the valuation variables, and we analyzed the sensitivity of the valuation model.

For example, the risk inherent in an investment in a new prescription drug is demonstrated by considering the internal rate of return an investor would enjoy if the investor paid \$12 million for the new drug patent. The overall internal rate of return of 36.2 percent is at the level needed to attract venture capital. This is the required rate of return that the analyst may use if presented only with a life-cycle projection—where the individual stages of development (and failure) are not discretely analyzed.

When a different risk-adjusted present value discount rate is applied to the cash flows expected from the commercialization of the new drug patent, a range of internal rates of return is developed (see Table 5 below).

Table 5
New Prescription Drug Patent
Internal Rate of Return Analysis (%)

		IRR
Discount Rate	9.0%	32.3%
	10.0%	33.6%
	11.0%	34.9%
	12.0%	36.2%
	13.0%	37.6%
	14.0%	39.0%
	15.0%	40.4%

Before deciding on the breadth and depth of the sensitivity analysis, the analyst may reconsider (1) the purpose and objective of the analysis, (2) the bundle of intellectual property legal rights being analyzed, and (3) the standard and premise of value being used. The ultimate audience (e.g., level of sophistication, degree of familiarity with the analysis) for the work product may affect how the sensitivity analysis is undertaken. Also, the sensitivity analysis may depend on whether the analysis is being used for notational (e.g., monitoring progress) versus transactional (e.g., buying or selling) purposes.

For example, a Monte Carlo simulation could be designed to take into consideration possible outcomes, success of entry and market positions, expense ratios, rates of return, and so on. As more valuation variables are included, more outcomes are possible. The average of the outcomes is not only influenced by the averages of the random variable used. The average of the outcomes is also influenced by the distributions and variances from the random valuation variable draws.

Thousands of valuation "trials" can be simulated. While any point in the range of outcomes is equally possible in a Monte Carlo simulation, the point most representative

of the range is usually the median. At the end of a Monte Carlo simulation, the analyst checks the reasonableness of the result. One way to develop a sense of reasonableness would be to develop a set of financial projections like the one illustrated in this article.

In this example, before phase I clinical trials commence, the value of the new drug patent is estimated to be \$12 million. After making the \$12 million investment to acquire the rights to the new drug, this investor understands that he cannot just sit back and clip coupons. This investor has earned the right to fund the losses that are projected for the next six years before generating any revenue (to say nothing of generating any positive cash flow).

Continuously during the drug development process, the intellectual property owner needs to keep abreast of the drug's development in order to (1) manage costs, (2) modify the projections based on current results and the external market environment, and (3) sell or abandon the project as soon as major obstacles or failure is imminent.

When an inventor can diversify the many risks inherent in developing a new prescription drug, the cost of capital is reduced and the return on investment increases. Some early-stage investors share the risks by only becoming involved in start-up ventures where a management team with previous experience running such a venture is already in place. Risks can also be reduced by owners of early-stage ventures by entering into royalty agreements or joint ventures with others who will contribute the skills necessary at certain stages of the new drug's development. Sometimes large pharmaceutical companies will, in exchange for contractual rights or equity, provide funding for the development of promising new drugs in the form of grants or payments for achieving certain development process milestones.

These factors can be built into the cash flow projections (e.g., provide revenue earlier in the form of milestone payments, improve margins) or by lowering the risk-adjusted present value discount rate.

SUMMARY AND CONCLUSION

Developing a commercially successful new prescription drug is expensive and risky. To attract investors, such a project requires a very high rate of return. The value of the pharmaceutical intellectual property depends on the projected financial results of the new prescription drug product. In this article, we discussed some of the factors an analyst should consider (1) in making financial projections and (2) in analyzing the reasonableness of those projections.

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Table 1
New Prescription Drug Development Decision Tree

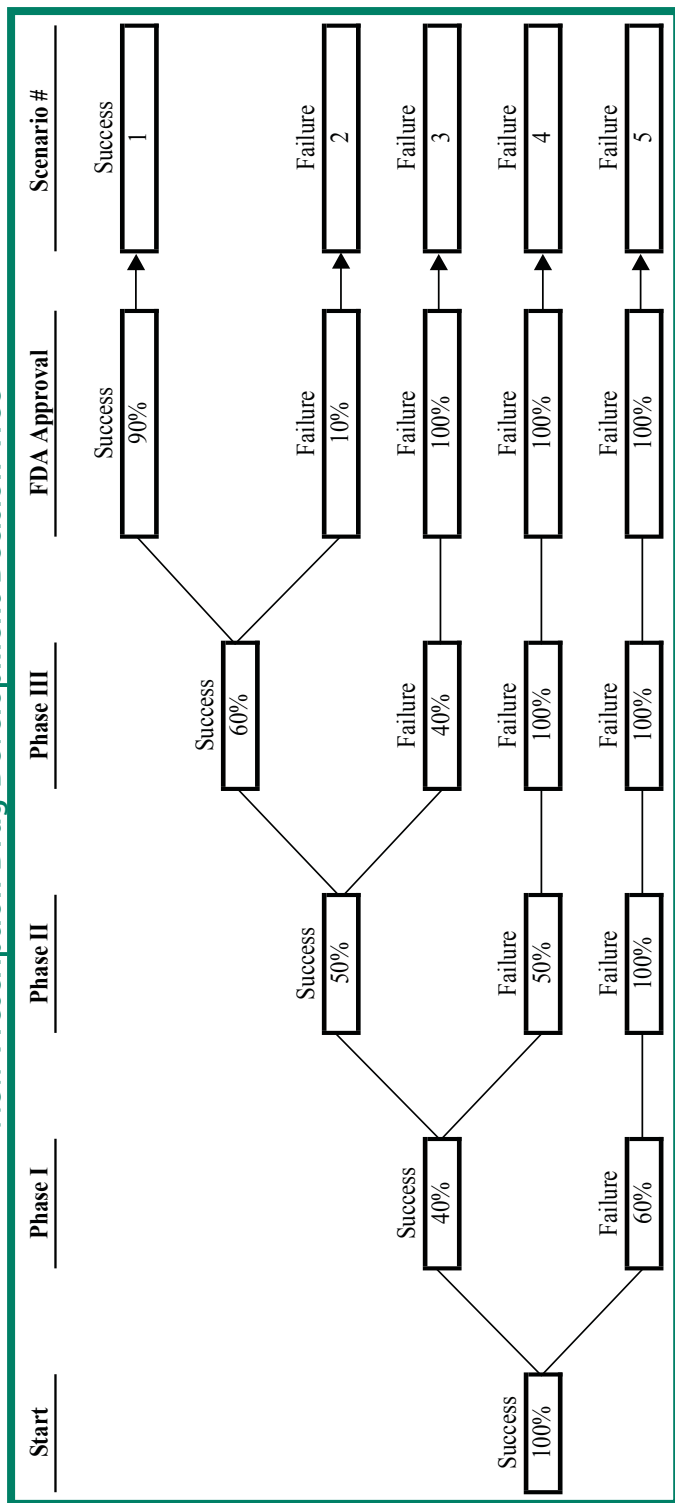


Table 2
New Prescription Drug Pro Forma Income Statement

Development Stage	Market Commercialization																	
	Phase I			Phase II			Phase III [a]			Pro Forma			Year 10 - 17				Generic	
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14	Year 15	Year 16	Year 17	
	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000	\$000
Product Market:																		
Market Size	1,000,000	1,030,000	1,060,900	1,092,727	1,125,509	1,159,274	1,194,052	1,229,874	1,266,770	1,304,773	1,343,916	1,384,234	1,425,761	1,468,534	1,512,590	1,557,967	1,604,706	
Market Share	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	5.0%	10.0%	20.0%	30.0%	40.0%	35.0%	30.0%	25.0%	20.0%	15.0%	5.0%	
Revenue	-	-	-	-	-	-	59,703	122,987	253,354	391,432	537,567	484,482	427,728	367,133	302,518	233,695	80,235	
Gross Profit	-	-	-	-	-	-	29,851	61,494	126,677	195,716	268,783	242,241	213,864	183,567	151,259	116,848	40,118	
Operating Expenses:																		
SG&A	1,000	1,000	1,000	1,000	1,000	1,000	10,000	15,000	20,000	25,000	30,000	30,000	30,000	30,000	25,000	20,000	15,000	
R&D	2,000	2,000	2,000	2,000	5,000	10,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	
Total Operating Expenses	3,000	3,000	3,000	3,000	6,000	11,000	12,000	17,000	22,000	27,000	32,000	32,000	32,000	32,000	27,000	22,000	17,000	
Operating Income	(3,000)	(3,000)	(3,000)	(3,000)	(6,000)	(11,000)	17,851	44,494	104,677	168,716	236,783	210,241	181,864	156,567	124,259	94,848	23,118	
Income Taxes [b]	-	-	-	-	-	-	7,141	17,297	41,871	67,486	94,713	84,096	72,746	62,627	49,704	37,939	9,247	
Net Operating Income	(3,000)	(3,000)	(3,000)	(3,000)	(6,000)	(11,000)	10,711	26,696	62,806	101,230	142,070	126,145	109,118	93,940	74,555	56,909	13,871	

Footnote:
 [a] FDA approval is assumed to be received immediately after the phase III approval stage.
 [b] Excludes adjustments for NOLs.

Table 3
New Prescription Drug Development Discounted Cash Flow Analysis

Development Stage	Phase I			Phase II			Phase III [a]			Market Capitalization							Generic
	Year 1 \$000	Year 2 \$000	Year 3 \$000	Year 4 \$000	Year 5 \$000	Year 6 \$000	Year 7 \$000	Year 8 \$000	Year 9 \$000	Year 10 \$000	Year 11 \$000	Year 12 \$000	Year 13 \$000	Year 14 \$000	Year 15 \$000	Year 16 \$000	Year 17 \$000
Net Operating Income	(3,000)	(3,000)	(3,000)	(3,000)	(6,000)	(11,000)	10,711	26,696	62,806	101,230	142,070	126,145	109,118	93,940	74,555	56,909	13,871
Recovery of Capital Charge	2,000	2,000	2,000	2,000	2,000	2,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	5,000	5,000
Capital Charge	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(5,000)	(5,000)
Operating Working Capital Requirements	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)
Net Cash Flow	(4,000)	(4,000)	(4,000)	(4,000)	(7,000)	(12,000)	8,711	24,696	60,806	99,230	140,070	124,145	107,118	91,940	72,555	54,909	11,871
Present Value Factor @ 12% [b]	0.9449	0.8437	0.7533	0.6726	0.6005	0.5362	0.4787	0.4274	0.3816	0.3407	0.3042	0.2716	0.2425	0.2165	0.1933	0.1726	0.1541
Present Value of Discrete Net Cash Flow (\$000)	(3,780)	(3,375)	(3,013)	(2,690)	(4,204)	(6,434)	4,170	10,556	23,206	33,812	42,614	33,723	25,980	19,910	14,028	9,479	1,830
Valuation Summary:																	
Present Value of Discrete Net Cash Flow Through Generic Stage (Scenario #1)																	
Present Value of Discrete Net Cash Flow Through FDA Approval Stage (Scenario #2) [a]																	
Present Value of Discrete Net Cash Flow Through Phase III Stage (Scenario #3)																	
Present Value of Discrete Net Cash Flow Through Phase II Stage (Scenario #4)																	
Present Value of Discrete Net Cash Flow Through Phase I Stage (Scenario #5)																	

Footnote:
[a] FDA approval is assumed to be received immediately after phase III approval stage.
[b] Calculated as if cash flow received at mid-year.

Table 4
New Prescription Drug Development Weighted Discounted Cash Flow Analysis

Development Stage Scenario #	Start	Development Stage Outcome Probability			FDA Approval	Development Stage		Present Value of Discrete Net Cash Flow \$000	Probability Weighted Value \$000						
		Phase I	Phase II	Phase III		Scenario Probability	Discrete Net Cash Flow \$000								
1	100%	x	40%	x	50%	x	60%	x	90%	=	11%	x	195,812	=	21,148
2	100%	x	40%	x	50%	x	60%	x	10%	=	1%	x	(23,495)	=	(282)
3	100%	x	40%	x	50%	x	40%	x	100%	=	8%	x	(23,495)	=	(1,880)
4	100%	x	40%	x	50%	x	100%	x	100%	=	20%	x	(12,858)	=	(2,572)
5	100%	x	60%	x	100%	x	100%	x	100%	=	60%	x	(7,154)	=	(4,293)
											100%				
										Indicated Value of New Prescription Drug Patent		12,122			

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VALUATION-RELATED FINANCIAL ADVISORY SERVICES FOR BANKRUPTCY PURPOSES

Robert F. Reilly and Ashley L. Reilly

Although the number of business bankruptcy filings has decreased somewhat since the mid-1990s, there continues to be a significant number of industrial and commercial companies for all sizes filing for bankruptcy protection. This article describes ten common reasons why financial advisers may have to perform valuation services related to an industrial or commercial company debtor in bankruptcy. And, this article describes seven common factors that a financial adviser should consider when performing a bankruptcy-related valuation.

INTRODUCTION

The 2004 and the 2005 year-to-date numbers of business bankruptcy filings were somewhat lower than the "record" number of filings in the mid-1990s. However, there is still a significant number of business bankruptcy filings each year. These business bankruptcy filings relate to companies across virtually all industrial and commercial sectors. A number of factors have contributed to this continuation in the number of business bankruptcy filings. These factors include the following:

1. a generally stagnant national economy,
2. a general increase in foreign competition,
3. overcapacity (and the related product/service price competition) in the domestic market segments,
4. continually increasing R&D expenditure requirements, and
5. the increasing costs of debt and equity capital financing for facilities and equipment.

The bankruptcy of an industrial or commercial company often involves the valuation of the assets, properties, and business interests included in the bankruptcy estate. This article summarizes many of the common reasons for conducting a valuation of industrial or commercial company businesses or assets for bankruptcy purposes. However, this article is not intended to provide a comprehensive listing of all of the reasons to conduct a bankruptcy-related valuation analysis.

This article will also summarize some of the general factors that the financial adviser should consider in the bankruptcy valuation of a typical industrial or commercial company.

REASONS TO CONDUCT A BANKRUPTCY VALUATION

1. Adequate Protection of Creditor Security Interests

Under the Bankruptcy Code, a creditor with a secured claim is entitled to adequate protection of the property interests when that creditor requests relief from the automatic stay. Adequate protection for the secured creditor property interest is also required before either the debtor-in-possession or the bankruptcy trustee can use, sell, or lease certain kinds of collateral.

One of the provisions related to the creditor "adequate protection" specifically concerns the value of the creditor's collateral property. If the value of the creditor's collateral property will decrease during the bankruptcy proceedings, then the bankruptcy trustee may be required to make payments to the creditor in order to provide for that adequate protection.

However, with regard to this creditor collateral valuation, the Bankruptcy Code does not specify either (1) what business/asset valuation methods are to be used or (2) what is the appropriate valuation date to be used.

For purposes of ensuring adequate protection, the courts have allowed various premises of value with regard to the valuation of the creditor's secured claim. For example, various courts have alternatively allowed (1) going concern value, (2) a wholesale price value, and (3) a sale price at a court-ordered sale—all as acceptable premises of value with regard to the valuation of a creditor's collateral.

Within the going concern premise of value, the courts have generally accepted the income approach, and specifically the discounted cash flow method, to value the creditor's security interest.

2. “Splitting” of the Under-Secured Creditor Claims

This “splitting” of the secured creditor's claim procedure occurs when a creditor claim has a market value that is less than the face amount of the claim. In that event, the secured creditor claim is divided into two parts: (1) a secured claim to the extent of the actual collateral market value and (2) an unsecured claim to the extent of the collateral value deficiency.

This collateral property valuation should consider both (1) the current use of the collateral property and (2) the proposed disposition or use of the collateral property.

Under the Bankruptcy Code, the determination of the factors that affect the value of the collateral property should be made in conjunction with a judicial hearing (1) on the disposition or use of the subject collateral assets or (2) on a plan of reorganization affecting the creditor security interest.

The collateral property valuation may affect the creditor's voting power to accept or reject a proposed reorganization plan. And, the collateral property valuation may affect the amount of distributions made to the creditor under a reorganization plan.

3. Determining Debtor Insolvency Related to Avoidance Actions

The corporate debtor's insolvency is a required condition for certain avoidance actions allowed under the Bankruptcy Code. For example, for certain payments to creditors to be considered preference items or fraudulent transfers (and, therefore, to be considered voidable), the corporate debtor must be insolvent at the time of the transfer.

Under the Bankruptcy Code, the term “insolvent” means that the value of the debtor's liabilities exceed the value of the debtor's assets, estimated at fair value. This is the only test of insolvency (i.e., the balance sheet test) that is needed to classify payments to creditors as preference items.

Accordingly, the determination of insolvency requires a valuation of both (1) the corporate debtor's assets (both tangible and intangible) and (2) the corporate debtor's liabilities (both short term and long term). This solvency “balance sheet” valuation is typically performed as of the date of the transfers from the debtor to the creditor.

However, the Bankruptcy Code does not specify what are the appropriate valuation approaches, methods, or procedures to use with regard to the valuation of the debtor's assets and liabilities.

For claims of fraudulent conveyance, the debtor corporation has to fail any one of the following three solvency tests: (1) the balance sheet test (i.e., does the fair value of

the debtor assets—both tangible and intangible—exceed the value of the debtor liabilities?), (2) the cash flow test (i.e., will the debtor be able to pay its debt service obligations as they mature?), and (3) the adequate capital test (does the debtor have an unreasonably small level of capital?).

4. Determining the Best Interest of a Creditor under Chapter 11

Under the Bankruptcy Code, a creditor must (1) accept a plan of reorganization or (2) receive/retain property under a plan of reorganization that is not less than the amount the creditor would receive/retain if the debtor were in liquidation. The appropriate valuation date for this purpose is the effective date of the plan of reorganization.

With regard to determining the best interest of the creditor, the valuations are typically performed under the premise of value in exchange on an orderly disposition basis—and not under the premise of value in exchange on a forced liquidation basis.

For this purpose, the premise of value in exchange on a liquidation basis is usually used to determine if the plan of reorganization (as opposed to a plan of liquidation) is in the best interest of the creditors. However, the valuation premise of value in continued use, as a going concern, is usually used in determining whether a creditor class should accept or reject the plan of reorganization.

5. Determining if a Plan of Reorganization Is Fair and Equitable to a Dissenting Creditor Class in Chapter 11

To determine whether a proposed plan of reorganization is fair and equitable to a dissenting creditor class, values are typically determined for those creditors' property collateral. In addition, the present value of the expected future payments under the proposed plan of reorganization are typically quantified.

The present value of the expected future payments is typically determined by discounting the dollar amounts expected to be received under the reorganization plan to a present value. However, for this purpose, the Bankruptcy Code does not define the basis or methodology for determining the appropriate present value discount rate.

If the existing corporate shareholders are to receive nothing under the plan of reorganization, then a valuation of the subject business equity may be required. This business valuation is used to demonstrate that the existing stockholders have no equity value left in the subject business.

Alternatively, let's assume that the existing shareholders will have control of the debtor after the bankruptcy. In that case, the shareholders must either:

1. demonstrate that the unsecured creditors will retain or receive property with a present value equal to the amount of their unsecured claims (to satisfy the “absolute priority rule”) or
2. contribute sufficient “new value” to repurchase control of the debtor (sometimes called the “new value exception” to the “absolute priority rule”).

It is noteworthy that some courts have not recognized the so-called “new value exception.”

In addition, the debtor business equity valuation is typically important to the determination of whether the proposed plan of reorganization is eligible for the accounting “cramdown” procedure.

6. Determining the Feasibility of the Proposed Plan of Reorganization

The feasibility of the proposed plan of reorganization relates to the soundness of the proposed capital structure of the debtor. The feasibility of the proposed reorganization plan also relates to whether the debtor has a reasonable prospect for financial recovery.

Confirmation of the proposed reorganization plan may not be approved by the court if the reorganization plan is likely to be followed by:

1. the debtor’s liquidation or
2. the need for further financial reorganization of the debtor.

Accordingly, a business valuation of the debtor entity may be required to demonstrate the feasibility (or the reasonableness) of the proposed plan of reorganization.

7. Debtor Property of Inconsequential Value

The concept of inconsequential value is important in several bankruptcy-related instances. For example, a secured creditor will lose its election to forego the unsecured deficiency claim in exchange for considering all of the claims secured in a Chapter 11 proceeding (the so-called “section 1111(b)(2) election”). This is true if the secured creditor’s collateral interest in the debtor’s property is of an “inconsequential value.”

As another example, the bankruptcy trustee may abandon (or may be required to abandon) property of the bankruptcy estate that is of “inconsequential value” to the estate.

Accordingly, a valuation of the debtor entity assets may be required to demonstrate which assets are of “inconsequential value.”

8. Planning Corporate Transactions During the Bankruptcy

A business valuation of the debtor corporate entity is typically needed in situations where the debtor-in-possession (or trustee) is planning a significant corporate transaction, such as a merger or acquisition.

Similarly, when assets of the bankruptcy estate are to be transferred in other than an arm’s-length transaction, a valuation of the debtor entity assets is typically necessary.

9. Fraudulent Conveyance Transfers

Transfers by a debtor may be avoided as fraudulent if the assets are transferred for less than their reasonably equivalent value. A fraudulent transfer occurs if the debtor corporation:

1. was insolvent or becomes insolvent due to the transfer,
2. was engaged after the transfer in a business with an unreasonably small amount of capital, or
3. intended to incur debts that would be beyond the debtor’s ability to repay.

In assessing a fraudulent/voidable creditor transfer, the “reasonably equivalent value” may consist of (1) property, (2) satisfaction, or (3) the securing of either a present or antecedent debt. Accordingly, the determination of a voidable fraudulent transfer may require both:

1. a valuation of the property transferred by the debtor corporation, and
2. a valuation of the property received by the debtor corporation.

10. Securities Given to a Creditor Class as Part of a Proposed Plan of Reorganization

Consideration or compensation distributed under a plan of reorganization in a Chapter 11 proceeding may consist primarily of securities of the reorganized debtor. The value of these distributed securities, which determines the amount of compensation given to a creditor class, depends on the valuation of the reorganized debtor corporation.

Accordingly, valuations are typically required for both:

1. the debtor corporation business enterprise under the plan or reorganization and
2. the particular debtor corporation securities subject to distribution to a creditor class under the reorganization plan.

GENERAL CONSIDERATIONS RELATED TO A BANKRUPTCY VALUATION

In a valuation of the debtor business enterprise, securities, or assets, the financial adviser should consider a number of general valuation factors. Some of these general valuation factors include:

1. any federal or state regulations that affect companies operating in the debtor corporation's subject industry;
2. the costs of capital components for (a) the subject debtor corporation, (b) the most likely population of typical buyers for the subject debtor corporation, and (c) the industry in which the subject corporation operates;
3. any unique intangible assets that may exist within the subject debtor corporation—and the effect of any industry-specific regulations on the value of the subject intangible assets;
4. the debtor corporation strategic strengths, weaknesses, opportunities, and threats vis-à-vis the subject debtor's competitor companies;
5. the cost/volume/profit relationships in the subject industry that affect (a) economies of scale, (b) economies of scope, and (c) any other factors that may influence consolidation trends;
6. antitrust considerations with regard to mergers and consolidations in the industry in which the subject debtor corporation operates;
7. the impact of (a) governmental regulation with regard to the development and commercialization, (b) domestic competition, and (c) foreign competition transfer of products and services; and
8. the economic effects of (a) an industry-specific product life cycle development phase, (b) industry-specific R&D expenditure and capital expenditure requirements, and (c) industry-specific intellectual property protections.

Financial advisers should consider these (and any other appropriate) general factors in the bankruptcy valuation of an industrial or commercial company.

SUMMARY AND CONCLUSION

When an industrial or commercial company files for bankruptcy protection, there are numerous reasons to perform a valuation of the bankruptcy estate assets, properties, or business interests. This article presented a “top 10” listing of the common reasons to perform bankruptcy-related valuations. However, it should be noted that this “top 10” list (1) is not intended to be a comprehensive list and (2) is not presented in any particular order of importance or priority.

When one of these “top 10” valuation reasons arises in a bankruptcy proceeding, the parties to the bankruptcy (including the debtor in possession, the various secured and unsecured creditor committees, and their respective legal counsel) should retain a financial adviser who is experienced:

1. in bankruptcy-related valuation issues and
2. in providing financial advisory services to participants of the subject industry.

Financial advisers should not attempt to be bankruptcy lawyers, of course. However, a financial adviser who performs bankruptcy-related valuation services should be generally familiar with the related statutory authority and administrative procedures with regard to a bankruptcy proceeding.

In addition, all parties to the bankruptcy should be aware of the regulatory, accounting, and competitive issues that are unique to the subject industry. Therefore, the financial adviser should have specific experience and expertise with regard to the valuation of businesses, securities, and tangible and intangible assets in the particular industry in which the debtor company operates.

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Ashley Reilly is an intern of the firm and is also resident in the Chicago office. Ashley can be reached at alreilly@willamette.com.

We are pleased to announce that

Lynn H. Whang

has joined the firm as an associate
in our Washington, D.C., office

Lynn has joined the valuation consulting practice of the office. She specializes in the valuation of businesses, business interests, debt and equity securities, and intellectual properties, for purposes of: transaction opinions, financings, taxation, bankruptcy, litigation, and strategic planning.

Prior to joining the firm, Lynn was a budget analyst with the International Trade Association in Washington, D.C., Before that, she was an assistant branch manager for the Farmers Bank of Maryland.

Lynn holds a BA degree in economics (with honors) from Boston College, and she holds an MBA degree in international finance from George Washington University.

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THE INDEPENDENT FINANCIAL ADVISER'S ROLE IN PREPARING SOLVENCY OPINIONS FOR ACQUISITION FINANCING TRANSACTIONS

Robert F. Reilly and Lyle A. Chastaine

Independent financial advisers perform solvency analyses—and issue solvency opinions—for a number of bankruptcy-related purposes. Claims of avoidable preference items require only that the financial adviser demonstrate that the total value of the debtor's liabilities exceed the total fair value of the debtor's assets. Claims of an avoidable fraudulent conveyance require that the financial adviser perform three solvency tests: (1) the balance sheet test, (2) the cash flow test, and (3) the capital adequacy test. This discussion summarizes the generally accepted financial adviser's procedures for preparing a solvency opinion.

INTRODUCTION

A solvency opinion is a transactional opinion prepared by a financial adviser that opines on the solvency of a debtor at the time of certain corporate actions. A solvency opinion is often prepared at the time of a corporate financing transaction, such as in a leveraged acquisition. A discussion of solvency opinions requires an explanation of the basic concepts of fraudulent conveyance.

First, this discussion will describe what a fraudulent conveyance—or a fraudulent transfer—is. Second, this discussion will explain (1) what a solvency opinion is and (2) when a solvency opinion is used in acquisition financing transactions. And, third, this discussion will summarize the analytical procedures that an independent financial adviser typically performs when assessing a pending financing in order to (1) conduct a solvency analysis and (2) issue a solvency opinion.

OVERVIEW OF FRAUDULENT CONVEYANCE

A fraudulent conveyance occurs when both of the following two conditions are met: (1) a transaction (or other corporate event) results in financial stakeholders receiving a benefit at the expense of unsecured creditors and (2) the company (a) is insolvent or (b) has unreasonably small capital or (c) has an inability to repay its obligations as they become due.

For purposes of determining if a fraudulent conveyance has occurred, the term insolvent (or insolvency) is defined as the situation where (1) a debtor company's liabilities exceed (2) the fair value of the debtor company's assets.

Litigation or other claims alleging an avoidable fraudulent conveyance are most frequently associated with bankruptcy proceedings.

Allegations that an acquisition financing results in a fraudulent conveyance can affect all the parties to the leveraged transaction, including the acquirer corporation directors, the secured creditors, and the target company sellers—that is, the parties who received the (financed) proceeds in the leveraged acquisition transaction.

It is noteworthy that fraudulent conveyance considerations can affect virtually all leveraged corporate transactions—and not just leveraged M&A transactions.

As an example of a fraudulent transfer that does not involve a leveraged acquisition, let's consider a closely held corporation that obtains a secured loan for purposes of funding either (1) a dividend or (2) a redemption of corporate stock. A successful claim of a fraudulent conveyance could result in:

1. the secured creditors losing their collateral,
2. the rescission of the corporate dividend or stock redemption transaction, and
3. the personal liability of the corporation's directors.

OVERVIEW OF THE SOLVENCY OPINION

A solvency opinion is a financial adviser's opinion that the corporation will not become insolvent as a result of a proposed financing transaction. Typically (but not always), the proposed transaction is a highly leveraged acquisition

or recapitalization transaction. The U.S. Bankruptcy Code defines insolvent as a ". . . financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation. . . ."¹

Typically, a solvency opinion—and the underlying financial and valuation analyses—address whether any of the following three financial conditions exists at the time of the leveraged transaction. The solvency opinion analyses are performed by applying three tests that represent the legal (and economic) standards of measuring solvency:

- Do the company liabilities (including the proposed financing) exceed the fair value of the company assets, determined through the balance sheet test?
- Does the company have adequate cash flow to meet its liabilities as they mature, determined through the cash flow test?
- Does the company have unreasonably small capital (including the effects of the proposed financing) determined through the reasonable capital test.²

Each of these three solvency tests is summarized below. It is important to note that a solvency opinion is based on information available and/or reasonably foreseeable as of the corporate transaction date.

Ironically, it is the information that is not reasonably foreseeable at the time of the financing transaction that frequently is the most controversial issue in the solvency-related litigation. This is because fraudulent conveyance claims are usually filed years after the subject financing is consummated—and after it becomes obvious that the debtor corporation was insolvent.

THE "BALANCE SHEET" SOLVENCY TEST

The balance sheet test determines whether the recorded value of a corporation's debts exceed the fair value of the corporation's assets at a specific point in time. This specific point in time is typically the hypothetical instant after the debtor corporation closes the subject financing transaction.

First, the balance sheet test involves the independent financial adviser valuing the corporation's assets at their highest and best use. The financial adviser's highest and best use analysis will determine the appropriate premise of value to use in the valuation of the corporation's assets. For the typical corporation that is operating as a going concern business enterprise as of the solvency test date, the appropriate premise of value is: value in continued use as part of a going concern.

Second, the balance sheet test involves the independent financial adviser subtracting the recorded value of the

corporation's liabilities from the estimated fair value of the corporation's assets. Typically, the financial adviser will use the recorded value (instead of the current market value) for the corporation's liabilities. Presumably, the recorded amount of the liabilities is the amount the debtor corporation would actually have to pay off as of the solvency test date. It is noteworthy that, for solvency testing purposes, the recorded amount of the corporation's liabilities includes the amount of the proposed financing transaction.

Third, when the fair value of the corporation's assets is greater than the recorded value of the corporation's liabilities, then the balance sheet test is passed. It is noteworthy that the balance sheet test is a "pass/fail" test. That means that the debtor corporation cannot be "just a little bit" insolvent. In other words, if the value of the debtor corporation liabilities exceed the value of the debtor corporation's assets by any amount, then the debtor corporation is insolvent.

The balance sheet solvency test typically begins with the financial adviser's going concern valuation of the debtor corporation total operating assets. (Of course, this statement assumes that the going concern premise of value represents the highest and best use of the debtor corporation total operating assets.)

The following discussion summarizes the valuation approaches and methods that an independent financial adviser typically uses in the valuation of the debtor corporation total operating assets.

The Balance Sheet Test Valuation Approaches and Methods

1. Income approach valuation methods, such as the discounted cash flow method and the direct capitalization method, are commonly used with regard to the balance sheet test. Financial advisers almost always use (and primarily rely on) income approach valuation methods in performing the balance sheet test. Other valuation approaches may also be used. But, the income approach is typically the principal approach with regard to the valuation. This is because income approach valuation methods are particularly applicable to solvency opinion valuation analyses.

As will be discussed later, income approach analyses are always used in the cash flow test of a solvency analysis. This is due to the necessity of considering whether or not the debtor corporation can discharge its debt service obligations as they mature.

By using the same basic income approach analytical model in the valuation of the debtor corporation assets, the financial adviser can ensure that there are consistent assumptions and projections used in both (a) the balance sheet (valuation) test and (b) the cash flow (debt service) test.

2. Market approach valuation methods may also be used in the balance sheet test in the appropriate circumstances. The common market approach valuation methods include: (1) the guideline publicly traded company method and (2) the guideline merged and acquired company method.

Market approach value indications are less applicable to the solvency analysis balance sheet test than are income approach value indications. This is because the market approach value indications are typically subject to the application of valuation discounts and premiums.

3. Asset-based approach valuation methods may also be used by the financial adviser in the balance sheet test. The common asset-based approach methods include: (1) the asset accumulation method and (2) the adjusted net asset value method.

These valuation methods are particularly relevant to the analysis of whether the fair value of the debtor corporation assets (both tangible and intangible) exceed the value of the debtor corporation liabilities.

Of course, the asset-based approach valuation of the debtor corporation tangible and intangible assets should be performed based on the going concern premise of value—if that premise represents the highest and best use of the subject total operating assets.

A detailed explanation of the generally accepted valuation approaches and methods is beyond the scope of this discussion. However, the independent financial adviser performing a solvency opinion balance sheet test should be intimately familiar with both the conceptual development and the practical application of all three generally accepted valuation approaches.

THE "CASH FLOW" SOLVENCY TEST

The cash flow test analyzes the debtor corporation's ability to meet its debt obligations as they come due.

As part of this test, the financial adviser will typically schedule out all future debt payments (both principal and interest) by due date. Then the financial adviser will analyze the debtor corporation's liquidity available to meet its debt requirements by estimating (1) excess cash available on the solvency date, (2) available cash flow generated during prospective periods, and (3) the availability of unused credit to the debtor corporation.

The cash flow solvency test is "passed" if (and only if), in every prospective period, the debtor corporation can pay its debt:

1. with cash accumulated from prior earnings,

2. with cash flow generated in the current period, or
3. with currently available credit resources.

The question answered by the cash flow test is whether the debtor corporation has the ability to meet its debt obligations (including the obligations associated with the proposed financing transaction) as they become due.

In the cash flow solvency test, it is important for the independent financial adviser to consider:

1. the amount by which the debtor corporation projected cash inflow exceeds the debtor corporation projected cash outflow, and
2. the increased risk associated with the proposed leverage transaction as the projected cash inflow and projected cash outflow amounts converge.

THE "REASONABLE CAPITAL" SOLVENCY TEST

The reasonable capital test determines whether the debtor corporation has adequate capital to meet its short-term (1) operating expense, (2) capital expenditure, and (3) debt service cash outflow needs.

In the reasonable capital test, the financial adviser typically analyzes the debtor corporation's expected financial performance under various operating scenarios, including the scenarios of:

1. management-prepared financial and operational projections, and
2. zero expected near-term growth and zero expected profit margin improvement.

The reasonable capital test is related, in part, to both the balance sheet test and the cash flow test. For example, even if the debtor corporation has assets that exceed its liabilities, the amount of capital available on the solvency date may be unreasonably small to allow the debtor to meet its operating needs in the near term.

This reasonable capital solvency test is "passed" if (and only if) the debtor corporation is expected in the short term to be able to (1) pay its current liabilities and the current portion of its long-term liabilities, (2) pay its payroll, research and development, and other operating expenses, and (3) make required capital expenditure investments. In other words, the debtor corporation must be able to fund its ongoing business operations.

While considered a separate and distinct solvency test, many financial advisers consider the reasonable capital test to be related to the results of both the balance sheet test and the cash flow test. This is because all three tests

analyze the debtor corporation's financial health on the solvency opinion date.

This reasonable capital solvency test involves the financial adviser's professional judgment that the amount by which the debtor corporation is solvent in the first two tests is not so small that the debtor corporation has an unreasonable small amount of working capital:

1. to fund its current business operations and
2. to provide a corporation's cushion in the event of a short-term business downturn.

As noted earlier, claims of fraudulent conveyance are frequently associated with bankruptcy proceedings. In such proceedings, it is often the case that unanticipated negative events either (1) caused or (2) contributed to the debtor corporation seeking bankruptcy protection. One objective of the capital adequacy (or reasonable capital) solvency test is for the financial adviser to determine if the debtor corporation will be able to withstand such an unanticipated negative event.

BENEFITS OF AN INDEPENDENT FINANCIAL ADVISER'S SOLVENCY OPINION

All stakeholders to the financing transaction have an interest in avoiding a claim of fraudulent conveyance. The secured creditors to the financing risk their security interest. The debtor corporation directors risk the assessment of personal liability. The recipients of the transaction (e.g., the target company sellers in the case of a leveraged acquisition) proceeds may be at risk to return all (or part) of the proceeds. The transaction's professional adviser fees may be at risk. Of course, for all parties to the leveraged transaction, litigation expenses related to a fraudulent conveyance claim can be considerable.

Corporation laws in many states permit debtor corporation directors to rely on the opinions of independent financial advisers as a defense to a fraudulent conveyance allegation. Of course, this reliance does not eliminate the fiduciary obligations and potential personal liability of the debtor corporation directors. However, the fact that the leveraged transaction participants retained an independent financial adviser to opine on the debtor corporation's solvency may reduce the potential of litigation—particularly when the debtor corporation has filed for bankruptcy protection.

As previously noted, a fraudulent conveyance is a fraud perpetrated in connection with a transaction that affects the rights of unsecured creditors. In the event of the debtor corporation's bankruptcy, the unsecured creditors may assert that corporate transactions in the period immedi-

ately prior to the bankruptcy could have caused the debtor to fail the solvency tests.

Of course, the financial adviser's ex post facto solvency analysis of the prebankruptcy debtor corporation transactions is performed with the benefit of perfect hindsight.

Contemporaneous solvency analyses are easier for financial advisers to perform than retrospective solvency analyses. And, in some instances, contemporaneously prepared solvency opinions may be more reliable than retrospective solvency opinions.

As time passes from the actual date of the transaction, it is more difficult for the financial adviser (1) to objectively assess the effect of the transaction on the debtor corporation and (2) to differentiate the economic effects of the subject transaction from the economic effects of an unrelated event. Accordingly, the importance of a contemporaneously prepared solvency opinion cannot be overemphasized in the context of a corporate capital transaction.

The independent financial adviser's solvency opinion—and the underlying financial analyses—reduce the risk to all parties to the corporate transaction in the following ways:

1. The results of the solvency analysis will assist the transaction stakeholders (and their legal counsel) in assessing whether the transaction may be alleged to be a voidable fraudulent conveyance in the unexpected event of a bankruptcy or other legal proceeding.
2. The existence of an independent financial adviser's opinion—and the documentation that the transaction stakeholders relied on that solvency opinion—may reduce the potential of post-transaction fraudulent conveyance litigation.
3. The existence of an independent financial adviser's solvency opinion may provide evidence that the transaction stakeholders (a) performed all reasonable procedures and (b) fulfilled all fiduciary and other legal duties to avoid perpetrating the alleged fraudulent conveyance.

SELECTING THE INDEPENDENT FINANCIAL ADVISER

In selecting an independent financial adviser to prepare a solvency opinion, it is important for the transaction stakeholders to consider the financial adviser's qualifications, experience, and expertise. It is noteworthy that the potential audience for the financial adviser's work product—and, therefore, the ultimate test of the transaction solvency opinion—may be a court of law.

Therefore, the selected financial adviser should have the appropriate experience and expertise to convince a

judicial finder of fact that he or she is professionally qualified to perform the solvency analysis.

An equally important factor in the selection of the solvency opinion provider is the independence of the "independent" financial adviser. Obviously, the independent financial adviser must be independent (in appearance and in fact) of the pending transaction.

The transaction stakeholders (and their legal counsel) should realize that it may be difficult to convince a judicial finder of fact of the "independence" of the financial adviser who: (1) negotiated the price and/or structure of the leveraged acquisition, (2) has received a performance fee or commission based on the price of the leveraged acquisition, or (3) does not receive a fee (or who receives a greatly reduced fee) if the pending leveraged acquisition does not close.

In addition, the transaction stakeholders (and their legal counsel) should recognize the risk of having the solvency opinion and/or expert testimony of the selected financial adviser disregarded by the court. That result may have the same effect as not having a financial adviser perform a contemporaneous solvency opinion.

SUMMARY AND CONCLUSION

The issues of a transaction fraudulent conveyance and of debtor corporation solvency are complicated. This statement is true both from the perspectives of (1) corporate financial economic analysis and (2) commercial and bankruptcy law. In a leveraged corporate capital transaction, errors in assessing debtor corporation solvency can be costly to a multitude of transaction stakeholders.

A contemporaneously prepared solvency opinion from an independent financial adviser is an important component of any defense against claims of (1) a voidable capital transaction fraudulent conveyance and (2) voidable preference payments.

Notes:

1. U.S. Bankruptcy Code, Section 548.
2. *Pereira v. Cogan*, 294 B.R. 449; 2003 U.S. Dist. LEXIS 7818 (2003).

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Book Review of Willamette Management Associates *Guide to ESOP Valuation* by William C. Ludwig

The *Guide to ESOP Valuation and Financial Advisory Services* ("the *Guide*"), published by Willamette Management Associates and edited by Robert F. Reilly and Robert P. Schweihs, is a compilation of employee stock ownership plan (ESOP) articles. The authors are some of the more well-known names in the ESOP community.

The *Guide* reflects the current thinking related to ESOP stock purchase/sale transactions, and it is meant for sophisticated ESOP practitioners as opposed to the general public. The *Guide* will also be useful to the management of companies that are contemplating the formation of an ESOP—and to their professional advisers. Some of the chapters are very detailed—taking the reader step-by-step through a transactional process, while other chapters are at an esoteric level—expressing the views of the particular expert author.

The book is logically developed, starting with structuring the ESOP transaction. The *Guide* next covers general ESOP valuation issues and then moves to special factors that affect the ESOP valuation. There are also sections near the end of the book devoted to the perspective of ESOP financial advisers and ESOP trustees. Finally, all of the topics are illustrated and summarized in an illustrative case study. This case study allows the reader an opportunity to visualize an actual ESOP valuation transaction.

The *Guide* is a valuable resource for anyone having any connection to ESOPs.

And the best thing of all—this book is free! (There is a nominal shipping charge—while supplies last.) It is a tough offer to pass up. Interested parties can request a copy of the book by contacting Mike Hartman at (404) 475-2311 or mrhartman@willamette.com.

William C. Ludwig is a principal in the firm of HPL&S Inc. located in Arlington Heights, Illinois. HPL&S designs and administers qualified retirement plans of all variety, and Bill has been actively involved with ESOPs for over 25 years. Bill may be reached at wcl@hplspen.com.

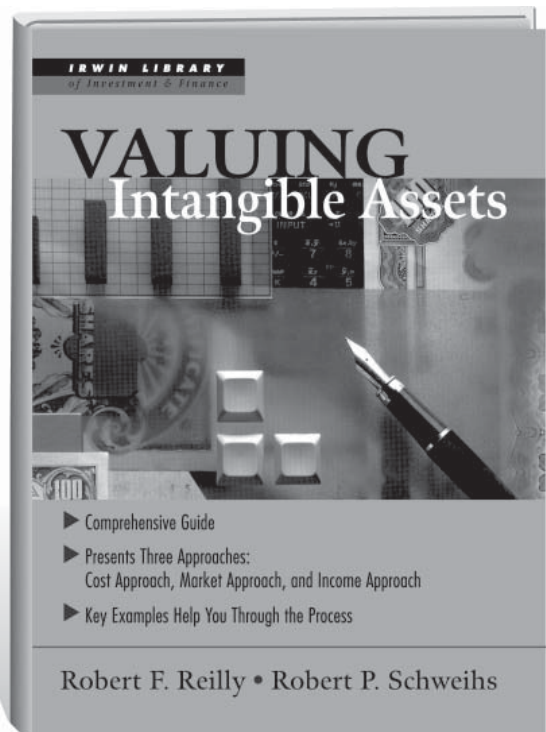
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THE ROLE OF THE INDEPENDENT FINANCIAL ADVISER IN THE ESOP FEASIBILITY, FORMATION, AND TRANSACTION FAIRNESS PROCESS

Malcolm R. Hartman

This discussion focuses on the role of the independent financial adviser in (1) identifying successful employer corporation candidates for an ESOP formation, (2) performing an ESOP formation feasibility study, and (3) preparing an ESOP stock purchase/sale transaction fairness opinion. This discussion is intended to provide guidance (1) to closely held corporation owners considering an ESOP formation and stock sale transaction and (2) to legal, accounting, and other ESOP professional advisers considering an ESOP stock purchase/sale transaction.

INTRODUCTION

This discussion is intended to provide guidance for closely held corporation owners who are considering (1) an employee stock ownership plan (ESOP) formation and/or (2) a leveraged ESOP stock purchase transaction. This discussion is also intended to provide guidance for employer corporation bankers, leveraged ESOP bankers, employer corporation accountants, employer corporation legal counsel, and ESOP legal counsel.

This discussion will focus on how an ESOP formation/company ownership transition transaction can provide a means of:

1. achieving the wealth enhancement, investment diversification, and asset monetization objectives of the closely held business owners and
2. providing a controlled ownership transition process to a friendly buyer (i.e., the company employees) through a tax-advanced transaction.

Financial advisers who provide professional services related to the installation of leveraged ESOPs frequently receive calls from business owners. These business owners own companies of all types and sizes. Many business owners have some limited information on the economic benefits of an ESOP formation. However, the business owners typically do not have enough information to make an informed decision on how a leveraged ESOP transaction would work in their particular company.

This discussion summarizes the attributes that financial advisers look for in a closely held corporation that make it a “good” candidate for an ESOP formation/stock purchase transaction. This discussion is based on our

experience at Willamette Management Associates (1) as independent financial advisers to both ESOP trustees (i.e., buyers) and closely held corporation owners (i.e., sellers) in ESOP stock purchase transactions, and (2) as investment bankers in leveraged ESOP employer corporation purchase/sale transactions.

As with any general discussion of a complicated issue, there may be many exceptions to the specific leveraged ESOP formation candidate criteria discussed herein.

This discussion will also present an overview of (1) the ESOP formation process and (2) the typical ESOP formation feasibility study.

Finally, this discussion summarizes the role of the independent financial adviser in the analysis of a pending employer corporation stock purchase/sale transaction. Specifically, this discussion focuses on the benefits of the financial adviser's (1) fairness analysis and (2) written fairness opinion in the assessment of a pending ESOP purchase/sale of employer corporation stock.

ESOP FORMATION CANDIDATE CRITERIA #1: CURRENT OWNERS' NEED FOR WEALTH DIVERSIFICATION

The employer corporation principal shareholders often have a need to diversify their personal wealth and investment portfolios. Typically, these individuals have spent most of their careers building and managing their closely held corporations.

However, because of their dedication to the family-owned closely held business, these otherwise successful individuals typically have not diversified their personal

wealth. Often, virtually all of their personal wealth is tied up in an illiquid ownership interest in the subject closely held corporation.

ESOP FORMATION CANDIDATE CRITERIA #2: CURRENT OWNERS' DESIRE FOR PERSONAL RETIREMENT AND OWNERSHIP SUCCESSION PLANNING

Closely held corporation shareholders (1) who want to begin the ownership succession planning process or (2) who are nearing retirement age should consider what ownership transition alternatives are available. For shareholders who are interested in maintaining some continuity in the management and ownership of their businesses, a leveraged ESOP transaction may be a viable alternative to the outright sale of the company to a third party.

Many closely held corporation owners do not begin the ownership succession planning process as early as they should. A leveraged ESOP transaction can be an effective mechanism for transitioning the employer corporation to the next generation of management and ownership. However, it is important to begin the ESOP formation planning process as early as possible so that the company ownership transition can be as orderly as possible.

There are numerous examples of closely held corporation shareholders who sold their shares to a newly formed ESOP—and then departed soon after the sale. However, without enough time to adequately train and prepare the successor company management team, a leveraged ESOP transaction may become a risky form of ownership transition.

ESOP FORMATION CANDIDATE CRITERIA #3: BUSINESS CYCLE CONSIDERATIONS

An employer corporation (1) that has been in business for a number of years and (2) that has demonstrated an established market will make the best candidate for a leveraged ESOP transaction.

In addition, the successful candidate for a leveraged ESOP will be an employer corporation that (1) is currently profitable and (2) is experiencing continued growth. The more reliable the company's expected earnings stream, the less risk there is in the ESOP's investment in the employer corporation stock.

In contrast, a leveraged ESOP transaction in an immature employer corporation can be problematic. The sale of a development stage company's stock to an ESOP will be at a much lower transaction price than the sale of a similarly sized mature company that has developed its markets, products, and services.

In the ownership transition planning process, financial advisers recommending a leveraged ESOP transaction should carefully analyze the growth prospects for the employer corporation. If the value of the employer corporation is likely to increase significantly in the future, (1) a current sale of a small percentage of the company stock or (2) a deferral of the sale to a later date may be in the current owners' best interests.

Alternatively, if the employer corporation stock is expected to continue on an established growth curve, then it may be appropriate to sell the entire company to an ESOP at its current fair market value. In this scenario, the selling stockholders will not miss out on any large future value increases.

ESOP FORMATION CANDIDATE CRITERIA #4: EMPLOYER CORPORATION SIZE

Leveraged ESOPs are more common in larger closely held corporations. For very small employer corporations, a leveraged ESOP transaction may not be practical. This is because there is a relatively fixed level of administration costs related to the formation and maintenance of a leveraged ESOP.

In other words, the cost of an ESOP formation is essentially fixed, regardless of the size of the employer corporation. These costs represent a small percentage of the company sale price for a large company (e.g., a company with an equity value over \$25 million). However, these costs can represent a large percentage of the company sale price for a smaller company (e.g., a company with an equity value below \$5 million).

The following discussion presents three "rules of thumb" regarding the minimum practical size for a leveraged ESOP formation/stock purchase transaction.

Number of Employees

There is no limit regarding how many employees an employer corporation must have in order to sponsor a leveraged ESOP. However, companies with fewer than 25 to 30 employees may find that the costs of installing a leveraged ESOP make such an ownership transition transaction economically impractical.

There is also the issue of the level of payroll amount required to support the required annual contributions to the ESOP plan. This issue is important because the Employee Retirement Income Security Act (ERISA) limits the amount of the annual employer contribution to the ESOP—and that limit is based on a percentage of employer corporation total payroll.

The National Center for Employee Ownership suggests that 20 may be an effective minimum number of employees

required to economically sponsor a leveraged ESOP. Our experience suggests that 30 to 40 employees may be a more realistic “rule of thumb” regarding the minimum number of employees required to economically accomplish a leveraged ESOP transaction.

Annual Revenue

Of course, the guideline level for the profitability of employer corporations varies greatly, even within the same industry. For this reason, using annual revenue as a guideline for ESOP suitability is not always a helpful rule of thumb. However, a leveraged ESOP formation is rare in companies with less than \$5 to \$10 million in annual revenue.

Profitability and Equity Value

In most cases, the value of the employer corporation equity can be estimated based on a pricing multiple multiplied by the company's historical/prospective profit. EBIT (i.e., earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation, and amortization), are commonly used measures of employer corporation profitability.

For example, let's assume that an employer corporation generates EBITDA of \$1,000,000. Based on that EBITDA level, the enterprise value may be in the range of \$3.5 million to \$5.5 million (before subtracting interest-bearing debt). Subtracting the company's outstanding interest-bearing debt would indicate the total equity value for the employer corporation. A “rule of thumb” is that the equity value of an employer corporation should be at least \$5 million in order for a leveraged ESOP transaction to be economically efficient.

ESOP FORMATION CANDIDATE CRITERIA #5: A STRATEGIC SALE VALUE IS NOT CRITICAL TO THE SELLERS

As a general rule, when the closely held corporation shareholders recognize the need to be conservative in extracting value through a sale to a leveraged ESOP, the transaction is more likely to go well. When the closely held corporation stockholders demand to obtain the absolute maximum price for their stock, a leveraged ESOP transaction is more likely to be unsuccessful.

Part of the leveraged ESOP planning process is a post transaction cash flow analysis. The employer corporation and its financial adviser should carefully analyze the expected financial condition of the corporation in the years after the sale. Both (1) the most-likely and (2) the worst-case financial operating scenarios should be considered in this analysis of prospective employer corporation results of operations.

The objective of this analysis is to ensure that the employer corporation:

1. will be comfortably able to amortize the leveraged ESOP debt and
2. will be able to react to unexpected business opportunities or contingencies as they arise.

ESOP FORMATION CANDIDATE CRITERIA #6: SUCCESSOR MANAGEMENT

A strong candidate for a leveraged ESOP will have a senior management team (1) that has been on board for several years and (2) that is actively involved in the ESOP formation planning. Such a management team will mitigate the ownership transition problems that often follow a sale of the principal shareholder's stock to an ESOP. In one recent ESOP transaction, the employer corporation senior management team included eight executives: the president, CFO, purchasing manager, director of manufacturing, and the company facility managers.

From the inception of the leveraged ESOP transaction planning, these managers were all actively involved in the planning process. After the ownership transition transaction was consummated, this management team was there to ensure that the ESOP-owned company would continue to be successful.

In contrast, the sudden departure of a key shareholder/employee can have a disruptive effect on the employer corporation. Let's consider the example of the company founder who developed most of the employer corporation's business relationships over the years. If that company founder suddenly decides to sell the employer corporation to an ESOP, those business prospects can be imperiled.

Accordingly, ESOP financial advisers should be particularly sensitive to key person dependent company sale transactions. This is because the ESOP investment in a “key person dependent” employer corporation carries with it higher risk—and correspondingly greater required returns. As a part of the employer corporation stock valuation process, the financial adviser will spend significant time talking to—and assessing the competency of—the subject management team.

ESOP FORMATION CANDIDATE CRITERIA #7: EMPLOYER CORPORATION CONTINGENT LIABILITIES

The employer corporation contingent liabilities should be discussed at the initial ESOP formation planning meeting. We have been involved in transactions where the employer

corporation is, in almost all ways, a good candidate for an ESOP transaction.

However, once we performed our due diligence investigation as financial adviser to the ESOP, we uncovered significant contingent liabilities. These contingent liabilities invariably became a significant barrier to the ESOP formation/leveraged stock purchase transaction.

In one situation, a manufacturer of specialty chemical products asked us to analyze the financial feasibility of a leveraged ESOP stock purchase transaction. The employer corporation management had some idea of what the fair market value of the employer corporation was. Therefore, the closely held business owners had some idea of what price a sale of the company to an ESOP would yield to the shareholders.

In fact, our estimated fair market value of the employer corporation was within the range of what company management thought it should be. After additional analysis, however, we found that the subject manufacturer had a serious ground water contamination problem. This contingent liability (i.e., the environmental cleanup costs) turned out to be a deal breaker. In this case, there could be no sale of the employer corporation stock to an ESOP without a full indemnification for the environmental liability to the ESOP trust.

It is often better to delay the implementation of an ESOP formation until such contingent liability issues are resolved. This is because the ESOP trustee will be understandably concerned over an investment in an employer corporation with such unresolved issues.

ESOP FORMATION CANDIDATE CRITERIA #8: MANAGEMENT OPENNESS TO THE BENEFITS OF BROAD BASED OWNERSHIP

Successful ESOP formation candidates tend to be corporations where the senior management fully supports the concept of broad-based employee ownership. In employer corporations where ESOP support only resides at lower management levels, communication of the ESOP benefits throughout the organization becomes difficult.

In such instances, the existence of the ESOP will not have the expected positive impact on the company prospective results of operations.

ESOP FORMATION CANDIDATE CRITERIA #9: AVAILABLE ACQUISITION LOAN COLLATERAL

Particularly with professional service firms, the amount of the ESOP acquisition loan collateral is an important issue. Loan underwriting criteria with respect to ESOP acquisi-

tion loans is pretty much the same as for any other kind of commercial lending. The ESOP lender is looking for security in the form of loan collateral. And, the ESOP lender will look to the employer corporation for unencumbered assets to serve as such collateral.

The issue of ESOP acquisition loan collateral should be an early planning issue both (1) for the employer corporation and (2) for the ESOP financial adviser. In the event that there is insufficient loan collateral, the selling shareholders may have to support the ESOP loan with the sale transaction proceeds. In circumstances where the seller shareholders pledge the proceeds as loan collateral, the selling shareholders continue to be at risk for the performance of the employer corporation.

THE ESOP FEASIBILITY STUDY

Most leveraged ESOP transactions begin as the proposed solution to a specific business owner's problem or need. The specific problem may be: how can the founder and/or principal stockholder get liquidity out of an investment in a closely held corporation? The successful implementation of a leveraged ESOP involves significant planning.

An ESOP feasibility study is the centerpiece of this planning. Such ESOP feasibility studies are typically performed by independent financial advisers with significant experience and expertise in (1) ESOP formations and (2) leveraged ESOP transactions.

The ESOP feasibility study may not necessarily result in a formal, bound report. However, if the financial adviser follows rigorous ESOP feasibility process, there will be fewer problems throughout the life of the plan.

THE ESOP FEASIBILITY PROCESS

The ESOP formation planning and feasibility process should be thorough and unhurried. The best first step for the employer corporation and the selling shareholders is to obtain enough material to permit them to become familiar with the basics of an ESOP formation.

In addition to information available from ESOP practitioners, a wealth of ESOP-related information is readily available on the Internet. Sites such as www.nceo.org and www.esopassociation.org contain background articles of all aspects of ESOP transactions. Further, there are a number of informative ESOP seminars offered around the country each year.

Once the selling shareholders have some basic understanding of what an ESOP is and how an ESOP works, an initial meeting with a financial adviser is necessary. Such an initial meeting normally includes (1) the ESOP's financial adviser and (2) ERISA counsel. This meeting may also

include (1) the employer corporation's accountant and lawyer and (2) the selling shareholder's financial adviser.

The result of this initial meeting should be a determination of whether a financial adviser should be retained to study the feasibility of an ESOP formation. The result of such an ESOP feasibility study should provide enough information for the shareholders to make a decision as to whether or not to proceed with the installation of an ESOP.

An often overlooked step in the ESOP feasibility process is for the financial adviser to encourage the principals to talk to peers at other companies that have implemented an ESOP. The selling principals should find out what has worked and what hasn't worked at those other employer corporations. Accordingly, the selling principals can avoid some of the more obvious pitfalls as the ESOP formation process moves forward. We find that most ESOP-owned corporation managers are more than willing to share their thoughts and ideas.

The results of the ESOP feasibility analyses are then presented to the selling principals and to their financial advisers. Based on this ESOP feasibility study, a decision can be made as to whether or not to proceed with the ESOP installation. Recognizing that there is an emphasis on confidentiality during the ESOP planning process, it is desirable to obtain input from as many advisers and managers as is practical.

CONTENT OF A TYPICAL ESOP FEASIBILITY ANALYSIS

The independent financial adviser will focus on a few basic procedures in conducting the ESOP feasibility study. These ESOP feasibility analysis procedures often include the following:

- Determine a possible range of values an ESOP may be able to pay for the employer corporation. This rough estimate is typically based on a limited amount of analysis, and it is not a valuation opinion based on thorough due diligence. The financial adviser will use generally accepted valuation approaches and methods (such as a discounted cash flow analysis and a guideline publicly traded company analysis) to arrive at a value estimate.
- Look for any barriers to a successful ESOP transaction (e.g., environmental, legal, corporate form, successor management, contribution deductibility issues, etc.). If conditions exist that would make the employer corporation sale impossible, the analysis should stop until a solution is found. Any number of potential sale barriers can arise.

Among the most common sale barriers are:

1. the selling shareholders have an unrealistic expectation of value,
 2. the employer corporation is too small with too few employees and payroll,
 3. the successor management is inadequate,
 4. the employer corporation growth rate has declined,
 5. employer corporation profits have been historically erratic,
 6. management has been previously unsuccessful in finding a buyer, and
 7. there are no unencumbered assets with which to collateralize an ESOP stock acquisition loan.
- Assess the impact on the employer corporation after the transaction is completed (both short-term and long-term). If the assumption of the ESOP acquisition debt will in any significant manner change the way the employer corporation is run, it is best to know this and to address this issue up front. An example of such a change would be the need to defer required capital expenditures into the future in order to amortize the ESOP stock acquisition loan.
 - Assess the ability of the ESOP (through the employer corporation) to finance a stock purchase transaction on reasonable terms. This analysis can be performed by the employer corporation management, by selling shareholders, or by the ESOP's financial adviser. The objective is to determine what kinds of terms may be available for the required financing, including collateral, guarantees, and use of the sale proceeds. Generally, two or more financial institutions would be asked (1) for input as to the particular proposed transaction and (2) to suggest alternative structures that may seem appropriate from the viewpoint of the lender.
 - Establish a basic proposed transaction structure, subject to changes as the ESOP formation planning moves forward. Basic issues such as whether an ownership control transaction will work, whether any seller financing should be considered, and whether a recapitalization may be necessary to get the deal done should be addressed. Many ESOP transactions change form as negotiations between the sellers and the ESOP trustee move forward. Nonetheless, without a basic structural framework, the ESOP feasibility study doesn't mean much.
 - Assess the impact on income/estate tax and retirement planning for the selling shareholders. Often this analysis is performed in conjunction with the seller's financial adviser and accountant/tax adviser. The formation of an ESOP presents unique estate planning opportunities that should be explored.

WHO IS THE FINANCIAL ADVISER'S CLIENT?

A discussion regarding who is working for whom in the ESOP feasibility process is appropriate. In a larger

transaction, the employer corporation is likely to retain a financial adviser to complete its work for the benefit of the shareholders and the board.

In these cases, an ESOP trustee is hired later in the process, and the ESOP trustee retains both a financial adviser and legal counsel. In this case, the ESOP trustee's financial adviser will make an independent assessment of the transaction as it is presented to him or her, rather than become directly involved in the planning process. The ESOP financial adviser's work results in an opinion for the ESOP trustee, and not for the employer corporation or for the selling shareholders.

For smaller, middle-market companies, the financial adviser may serve the ESOP trustee and, at the same time, be a part of the overall ESOP planning process. This is a practical means of reducing the costs of the ESOP formation/feasibility process.

In these cases, the financial adviser will usually address his or her work product to the ESOP trustee. This work product will contain all of the necessary ESOP feasibility information. Once a decision is made to implement an ESOP, the role of the financial adviser evolves to providing the financial opinions to the ESOP trustee at the close of the ESOP stock purchase transaction.

COST AND TIMING OF THE ESOP FEASIBILITY STUDY

The cost of an ESOP feasibility study will vary depending on facts and circumstances. The financial adviser may charge a fixed fee for his or her work, or the financial adviser may propose an hourly fee structure.

ESOP feasibility studies performed for smaller companies and informal reports tend to cost less than formal presentations to boards of directors of larger corporations. However, the engagement with the financial adviser can be structured so that if a barrier to a successful ESOP formation is found, the fee clock stops immediately.

The ESOP feasibility analysis is a critical step in the ESOP valuation process and is, in some cases, a practical requirement for the ultimate success of the ESOP installation. Therefore, the cost of such an ESOP feasibility study should be considered in the context of the whole project. The ESOP feasibility study is simply the first stage in the employer corporation valuation process.

An ESOP feasibility study can take only a few hours of analytical time, or it can be a thorough planning process taking several weeks or months. Since the ESOP formation process is intended to provide a solution to the selling shareholders' financial planning problem, a thoughtful, in-depth ESOP feasibility study may be the best investment the selling shareholders can make.

ESOP STOCK PURCHASE/SALE TRANSACTION FAIRNESS OPINIONS

In a potential ESOP purchase of employer corporation stock, the ESOP fiduciary has an obligation to consider the subject investment opportunity in comparison to other available investments. Other available investments are those investments that are considered reasonable alternatives to the proposed employer corporation stock purchase/sale transaction.

If appropriate due diligence investigation procedures are not followed, the ESOP fiduciary may be held personally liable for approving an unsound investment transaction. Therefore, a written fairness opinion from an independent financial adviser is an integral component of most ESOP stock acquisition transactions.

The objective of a transaction fairness opinion issued by an independent financial adviser is to ensure that the ESOP employer corporation stock purchase transaction can withstand the scrutiny of (1) the U.S. Department of Labor, (2) the Internal Revenue Service, and (3) the subject ESOP beneficiaries.

Typically in an ESOP stock purchase/sale transaction, the independent financial adviser is retained by the ESOP fiduciary. The ESOP fiduciary is responsible for representing the ESOP's interests related to the proposed stock purchase/sale transaction. As part of the due diligence procedures related to the proposed stock purchase transaction, the ESOP independent financial adviser is asked to provide a written opinion, known as a fairness opinion. The fairness opinion will state that the proposed employer corporation stock purchase/sale transaction is fair to the ESOP.

OVERVIEW OF AN ESOP FAIRNESS OPINION

A fairness opinion is a letter prepared by the ESOP's independent financial adviser that states whether or not the proposed stock purchase/sale transaction is fair to the ESOP. Fairness is assessed (1) from a financial point of view, (2) as of a specific date, and (3) based on certain assumptions, limitations, and procedures.

An ESOP stock purchase/sale transaction fairness opinion has two purposes:

1. to provide the ESOP fiduciary with essential information regarding the pending transaction and
2. to provide documentation that the ESOP fiduciary used reasonable business judgment in making the stock purchase/sale investment decision on behalf of the ESOP.

Although fairness opinions are not legally required in ESOP stock purchase/sale transactions, it is prudent for

the ESOP fiduciary to obtain such an opinion. In the event of a dispute or litigation over the transaction, the fairness opinion may help support a finding that the ESOP fiduciary made an informed business judgment.

It is important to note that a fairness opinion does not recommend an ESOP stock purchase/sale transaction. Nor does a fairness opinion provide a legal opinion on the ESOP stock purchase/sale transaction. It is the responsibility of the ESOP fiduciary to determine whether the pending stock purchase or sale transaction is appropriate. The financial adviser's role is to provide an opinion of the pending transaction "from a financial point of view."

In order to clarify the meaning of "from a financial point of view," ESOP participants should understand what a nonfinancial point of view is. In any employer corporation stock purchase or sale transaction, an ESOP participant may ask such questions as:

1. Is now a good time to buy—or to sell—the employer corporation stock?
2. I bought the employer corporation stock for a higher price than the pending deal price. How can this pending sale be fair to me?

These questions are certainly valid concerns for the ESOP participants. However, these queries involve different questions of transactional fairness that do not necessarily have anything to do with the transaction's financial fairness.

WHEN TO OBTAIN AN ESOP FAIRNESS OPINION

Fairness opinions may subject the independent financial adviser to professional liability exposure. Therefore, the independent financial adviser will expect to receive a substantial professional fee for this transaction opinion service. Accordingly, the ESOP fiduciary needs to weigh the known cost against the expected benefit when obtaining a fairness opinion.

Typically, the size and complexity of the employer corporation stock purchase/sale transaction is the primary factor that determines whether an ESOP transaction fairness opinion is needed.

The following list indicates the many situations (1) where a stock purchase/sale transaction involving an ESOP-owned company is subject to challenge and (2) where an independent financial adviser's fairness opinion may be appropriate:

1. the initial formation of the ESOP,
2. the final termination of the ESOP,

3. a significant purchase of employer corporation stock by the ESOP,
4. whenever there is a stock purchase/sale transaction between the ESOP and a controlling stockholder or a member of a control group, and
5. stock purchase/sale transactions outside of the ESOP that significantly affect the capital structure of the employer corporation that affect the value of the ESOP-owned employer shares.

In the first three situations, a fairness opinion from an independent financial adviser is obviously appropriate. There are less obvious situations where a change in the capital structure of the employer corporation could affect the value of the ESOP-owned shares—and for which the opinion of the ESOP's financial adviser may be helpful. Examples of such situations include the following:

1. New shares of the employer corporation common stock are issued—this could result in the dilution of the value of the ESOP-owned employer corporation shares.
2. A preferred security is created and distributed—this (a) may give another equity holder a superior right to employer corporation dividends and (b) may result in a decrease in the value of the ESOP-owned employer corporation stock.
3. The employer corporation takes on a large amount of long-term debt—the ESOP-owned employer stock value may decrease because another stakeholder has a superior claim in the case of the employer corporation liquidation.

THE ROLE OF THE TRUSTEE IN THE ESOP STOCK PURCHASE/SALE TRANSACTION

Every qualified ESOP is part of a trust that is governed by the Employee Retirement Income Security Act of 1974 (ERISA). Each trust is governed by a trust document that specifies the duties and responsibilities of the ESOP trustee. Under ERISA Section 404(a)(1), a fiduciary—that is, the ESOP trustee—must approach the employer corporation stock purchase/sale transaction "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

The employer corporation should carefully select the ESOP trustee, as the trustee's fiduciary obligations are significant. The ESOP trustee may be a "party in interest"—generally defined as a corporate officer, employee, or a more than 10 percent shareholder—but that is not

advisable. This is because a fiduciary can be held personally liable for his or her actions. Many employer corporations retain institutional trustees for purposes of independence. Ultimately, it is the ESOP trustee's responsibility to make the investment decision to purchase (or sell) the employer corporation stock on behalf of the ESOP.

ERISA Section 401(a)(28)(C) provides that, after 1986, all ESOP valuations of employer corporation securities that are not readily tradable must be conducted by an independent appraiser. Therefore, the financial adviser to the ESOP trustee must be independent of all parties to the leveraged ESOP stock purchase/sale transaction. The financial adviser should be retained by—and report directly to—the ESOP trustee. The agreement between the ESOP trustee and the financial adviser should define the type of transaction opinions that the independent financial adviser is expected to prepare.

The following discussion summarizes the different types of transaction opinions that the independent financial adviser may provide to the ESOP trustee.

The Adequate Consideration Opinion

The first (and arguably the most important) opinion that the financial adviser will prepare is whether the price paid by the ESOP for the employer corporation stock exceeds adequate consideration. Adequate consideration is defined by ERISA Section 3(18)(B) as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary. . . pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor."

Fair market value is defined by the U.S. Department of Labor proposed regulations as the amount at which the company stock would change hands between a willing buyer and a willing seller, each having reasonable knowledge of all relevant facts, neither being under any compulsion to act, and with equity to both. In order to analyze "adequate consideration," the independent financial adviser should conduct a thorough and well supported valuation analysis that (1) incorporates all appropriate business valuation approaches and methods and (2) provides the ESOP trustee with the necessary justification for the adequate consideration opinion.

Fairness from a Financial Point of View

The adequate consideration test is sometimes referred to as the absolute fairness test. Essentially, the adequate consideration question is: Does the stock price to be paid by the ESOP exceed some benchmark that represents fair market value? The "fairness from a financial point of view" opinion incorporates the concept of relative fairness. The

independent financial adviser should also advise the ESOP trustee as to whether the stock price to be paid by the ESOP is fair relative to the price that would be paid by any other investors.

The essence of the relative fairness test is a comparison of (1) the relative investment risk accepted by each investor and (2) the expected investment return associated with that risk. In the typical leveraged ESOP stock purchase transaction (where a senior lender provides all of the acquisition financing), the concepts of relative fairness and absolute fairness converge. Since there are no parties to the leveraged stock purchase transaction other than the senior lender, the determination of relative fairness is based on whether the terms of the senior financing are fair relative to the ESOP.

In a multi-investor ESOP structure, however, relative fairness becomes a significant issue. The allocation of equity to the various stock purchase transaction participants in the leveraged ESOP can affect the internal rate of return (IRR) earned by each participant. The relative IRRs can affect whether the stock purchase transaction is fair from a financial point of view. Accordingly, in stock purchase transactions with more than one investor, the ESOP trustee should be involved in structuring both (1) the employer corporation stock purchase by the ESOP and (2) the employer corporation stock purchase by the other transaction participants.

Measuring the IRR for each investor is one way to measure the fairness to the stock purchase transaction to each of the transaction participants. As investment risk increases among the various classes of employer corporation debt and equity securities, the expected rate of return should also increase. The subject transaction relative investment IRRs can be compared to empirical, market-derived returns of publicly traded securities with similar investment risk characteristics.

The Reasonableness of the Stock Conversion Premium

If (1) the ESOP purchases a security other than common stock and (2) that security has a dividend preference, then the ESOP trustee may require an opinion as to the reasonableness of the stock conversion premium. The stock conversion premium is measured as the price premium paid for the preferred dividend security over the value of the employer corporation common stock.

The value of a dividend preference security is typically equal to (1) the value of the employer corporation common stock plus (2) the value of the dividend preference. Therefore, the price premium paid for the preferred security is typically related to the value of the dividend preference.

To assess the reasonableness of the stock conversion premium, the independent financial adviser will typically consider guideline publicly traded securities with similar investment characteristics and risk attributes. The independent financial adviser will typically compare the (1) dividend coverage ratio, (2) capitalization ratio, (3) fixed charge coverage ratio, and (4) debt to equity ratio—between the employer corporation security and the guideline publicly traded securities. The financial adviser performs this comparison in order to assess the relative risks applicable to the employer corporation security, and therefore, the reasonableness of the stock conversion premium.

The Reasonableness of the ESOP Acquisition Debt Terms and Conditions

Since the terms of the employer corporation stock purchase transaction can also affect the purchase price, the financial adviser should also review the terms of the ESOP acquisition debt. The terms of the ESOP acquisition debt that can affect the stock price are (1) the interest rate and (2) the term of the financing. A comparison of the ESOP debt terms with empirical debt market evidence can indicate whether these terms are reasonable in the current economic environment. The financial adviser's analysis of current market interest rates should indicate whether the interest rate on the ESOP acquisition debt is a market interest rate.

The financial adviser should also consider the implied quality rating on the ESOP acquisition debt. The financial adviser typically performs that comparison with appropriately rated publicly traded debt instruments. For example, if the ESOP acquisition debt represents 80 percent of the employer corporation total invested capital value, that debt may be rated lower than if the ESOP acquisition debt represented only 20 percent of the employer corporation total invested capital value.

SUMMARY AND CONCLUSION

The nine ESOP formation candidate criteria described in this discussion can serve as a simple checklist for closely held corporation owners—and for their financial advisers. These individuals can use this checklist as they consider the difficult issues of:

1. close corporation ownership transition and management succession and
2. the diversification/ liquidity of the closely held corporation owner's wealth accumulation.

Careful planning prior to the implementation of a leveraged ESOP is critical to its long-term success. An ESOP

feasibility study can take different forms, and a formal feasibility report is not necessarily a requirement. What is important is that the financial adviser should carefully consider the needs of (1) the selling shareholders, (2) the employer corporation, and (3) the to-be-formed ESOP participants.

Implementing an ESOP can be one of the most important decisions in the life cycle of the employer corporation. The ESOP formation planning process should be performed with care, and it should involve all of the necessary financial and legal advisers.

Finally, ESOP fiduciaries are responsible for demonstrating that, during the course of analyzing the pending stock purchase/sale transaction: (1) appropriate due diligence procedures were conducted and (2) the purchase/sale transaction price was at fair market value. This responsibility for ESOP fiduciaries has been well established by judicial precedent.

Therefore, the written advice of the ESOP's independent financial adviser is important evidence in the analysis of a potential employer corporation stock purchase/sale transaction. The wisdom of obtaining an independent financial adviser's transaction fairness opinion is obvious if there is any chance that the ESOP fiduciary's investment decision may be challenged in the future.

Malcolm ("Mike") Hartman is a principal in our Atlanta office. Mike can be reached at (404) 870-0611 or at mrhartman@willamette.com.

We are pleased to announce that

Viraj Patel

has joined the firm as an associate
in our Atlanta office

Viraj has joined the valuation consulting practice of the firm. He specializes in the valuation of businesses, business interests, and debt and equity securities for gift tax, estate tax, ownership transition, buy-sell agreement, and other wealth transfer purposes.

Prior to joining the firm, Viraj was a financial analyst for Pike Nursery Holding, LLC, in Norcross, Georgia. Before that, he was a risk analyst for insurance broker Marsh, Inc., in Atlanta.

Viraj holds a BBA degree in finance and accounting (with honors) from the Georgia State University Robinson College of Business.



**King & Prince Seafood
Employee Stock Ownership Plan**

has sold its controlling interest in
King & Prince Seafood Corporation

The undersigned served as financial adviser to
the independent fiduciary of the
King & Prince Seafood Corporation
Employee Stock Ownership Plan



**Digicon Corporation
Employee Stock Ownership Plan**

has purchased an interest in
Digicon Corporation

The undersigned served as financial adviser to
GreatBanc Trust Company, trustee of the
Digicon Corporation
Employee Stock Ownership Plan



**Sunflower Landscaping
and Maintenance, Inc.
Employee Stock Ownership Plan**

has purchased a minority interest in

**Sunflower Landscaping
and Maintenance, Inc.**

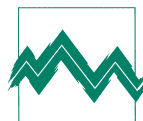
The undersigned served as financial adviser to
Brant Mackey, trustee of the
Sunflower Landscaping and Maintenance, Inc.
Employee Stock Ownership Plan

**LJT Industries, Inc.
Employee Stock Ownership
Plan & Trust**

has sold its controlling interest in

Taracorp Imaco, Inc.

The undersigned served as financial adviser to
the independent fiduciary of the
LJT Industries, Inc.
Employee Stock Ownership Plan & Trust



**Willamette Capital
Willamette Management Associates**

ESOP Financial Advisory Services Insights

"ESOPs EMERGE AS AN ATTRACTIVE EXIT STRATEGY" A REPRINT OF AN ARTICLE FROM THE JULY 25, 2005 ISSUE OF FACTSET FLASHWIRE WEEKLY

FactSet Flashwire Weekly recently interviewed Mike Hartman, a principal in our firm's ESOP financial advisory services practice. In this interview, which is reprinted below, Hartman describes the economic benefits of an ESOP formation as an exit strategy for the owners of a family-owned or other closely held business. In particular, a leveraged ESOP formation can provide significant corporate income tax advantages to the employer corporation/ESOP sponsor. And, a leveraged ESOP buyout of the employer corporation stock can provide significant capital gains tax deferral benefits to the selling shareholders.

An employee stock ownership program (ESOP) sounds like a 401k-type benefit for workers. But lately it's being talked about in M&A circles as valuation firms and middle-market M&A advisers are finding themselves busier than ever doing ESOP deals.

Mike Hartman, principal at Willamette Management Associates, a business valuation, analysis and financial advisory firm, said he is seeing a spike in demand as lenders lose their fear of ESOP lending. "I'm working on a US\$200 million deal – it's the biggest one I've ever had."

An ESOP transaction is typically set off by a business owner who is thinking about stepping away from the business, or withdrawing some equity, but is not ready to sell out entirely. A business owner gets a call from an equity firm or competitor interested in buying his company. Instead of reacting to that offer, the owner will call his or her banker or accountant and ask about what the alternatives are. "They think, I'm not ready to retire. Wouldn't it be nice to diversify some of my wealth?" said Hartman. "That's the beginning thought of many ESOPs we work on."

First, the value of the company must be determined. The company needs to have positive cash flow, as that will be partly used to pay off the ESOP loan. Once the business is valued, the company approaches lenders to determine their interest in lending for an ESOP transaction. Typically, the lender makes the loan to the company, which in turn loans to the ESOP trust. The ESOP then pays the business owner by buying stock in the company.

The rise of ESOP popularity is the result of a confluence of factors. Michael Ellington, managing director at M&A and valuation advisory firm Strategic Equity Group, said retiring baby boomers are generating more ESOP transactions

lately. Family businesses increasingly don't have second generations interested in taking over, but they aren't ready to sell out and retire either, he said. The ESOP can be a good way to take some equity out but still maintain ownership.

Lenders are more favorable to ESOP transactions than they used to be. "We went through a phase in the late '80s when ESOPs were done based on inflated values, and banks got burned," said Hartman.

"Now the industry has grown up and the people who do the valuations, the lawyers and the trustees are very, very careful." Traditionally, banks such as LaSalle tended to specialize in ESOP lending. But as banking consolidated, larger institutions began to recognize that doing ESOP loans was a way into establishing primary banking relationships.

Probably the number one reason that ESOPs have become so attractive is tax incentives that have been written into the laws in recent years. In 1997, the Internal Revenue Service changed its rules to allow ESOPs to be shareholders in S corporations, effectively making them tax-free entities. In addition, ESOP loans have become tax deductible, and capital gains taxes can be avoided if a business owner sells at least 30% of the value of the company to an ESOP.

Such tax breaks reflect what President Bush was talking about when he discussed in his inaugural speech the "ownership society" he wants to create, said Hartman. The biggest challenge for an ESOP company today? According to Hartman, it's explaining to employees how it works.

This article originally appeared in FactSet Flashwire Weekly. It is reprinted here with their permission.

Announcing . . .

Willamette Management Associates Guide to ESOP Valuation and Financial Advisory Services

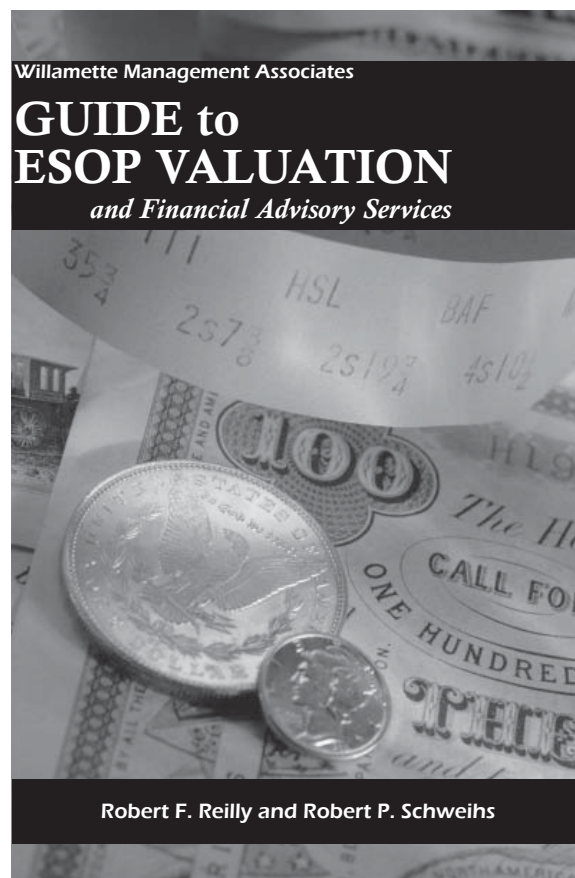
Published in 2005, this 443-page book presents a consensus of the current thinking with regard to ESOP formation, stock valuation, transaction structure, acquisition financing, independent financial adviser, and trustee fiduciary issues. It describes the practical applications of ESOP valuation, financing, taxation, and transaction structuring.

This book is intended to benefit practicing ESOP valuation analysts and ESOP independent financial advisers, ESOP trustees, ESOP legal counsel, ESOP accountants and auditors, ESOP administrators, and other ESOP professionals. It is also intended to benefit (1) the managers and non-ESOP stockholders of ESOP sponsor companies, (2) the current ESOP participants of employer corporations, and (3) the management and stockholders of companies that are considering an initial ESOP formation.

For this book, we selected "the best of" the ESOP valuation articles published in *Insights* during the last decade. In each case, we thoroughly edited and updated the original article so that the discussions presented in this book are both timely and topical.

Chapters in the book include Structuring the Leveraged ESOP Stock Purchase Transaction, Valuation of S Corporation Stock, and ESOP Valuation Discounts and Premiums.

This book presents clear, convincing, and cogent discussions of the current issues facing the ESOP valuation practitioner.



To order your complimentary copy, please return this order form—and a check for \$15 to cover shipping and handling only—to Stephanie Bowker at Willamette Management Associates, 8600 W. Bryn Mawr Ave., Suite 950-N, Chicago, IL 60631.

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Willamette Management Associates Insights

BOOK REVIEW OF *THE HANDBOOK OF BUSINESS VALUATION AND INTELLECTUAL PROPERTY ANALYSIS* EDITED BY ROBERT F. REILLY AND ROBERT P. SCHWEIHS

Reviewed by Martin J. Lieberman

This book review appeared in the February 2005 issue of *The CPA Journal*. It is reprinted with permission of the publisher. Martin J. Lieberman, CPA/ABV, ASA, is a partner and director of business valuation at Rosen Seymour Shapss Martin & Co., LLP, New York, N.Y. He is a member of the NYSSCPA Business Valuation Committee.

The Handbook of Business Valuation and Intellectual Property Analysis features the contributions of 29 experts from leading valuation, accounting, investment, and law firms, and provides a comprehensive review of contemporary valuation issues related to business, securities, and intellectual property. Several chapters are updates of a previous anthology compiled by the same editors, *The Handbook of Advanced Business Valuation*.

This new work's main contribution is its recognition of the importance of intangible assets in the information age. It addresses the enormous complexities associated with measuring the value of these assets in a practical context. This work is truly for the experienced professional; however, the novice can derive insight into this area as well.

There has been an explosion of intangible assets, which now make up the majority of many companies' asset base. One indicator of the value of intangible assets today is the relationship between book value and trading prices for public company securities. Prior to 1980, book value tracked security prices. Today, security prices are, to a large degree, very much in excess of book value. The reason is that accounting rules do not permit the recording of intangible asset values unless they have been purchased. The marketplace, however, recognizes the value of intangible assets, and this is reflected in security prices.

More than half the book is devoted to valuation topics other than intangible assets. The book is divided into six parts. Part I explores traditional valuation issues, including discussions of the elusive equity risk premium, minority interest and marketability discounts, built-in gains taxes, and S corporation valuations. Part II provides valuation methodologies for certain specialized industries, such as health care. Fairness opinions and the now-popular family limited liability companies are also discussed. Part III has an excellent chapter on identifying value drivers as an important means of arriving at more "correct" valuation conclusions. The exercise of identifying value drivers and quantifying their impact on company value contributes

enormously to achieving credibility in one's reports. The practice application to real-life valuation assignments, backed by theoretical underpinnings, is the hallmark of these chapters, as well as of the entire book. The chapter on quantifying economic damages is one that I found particularly useful.

Parts IV, V, and VI are devoted to intellectual property valuation issues, methodologies, and case studies, from the basic to the arcane. Part IV covers intellectual property valuation approaches, methods, and discount rates. Part V focuses on the estimation of transfer pricing, which is useful in nailing down more than just transfer prices for such cases. It also provides a methodology for constructing values in other types of assignments, using acceptable transfer pricing income tax methods as justification. Part VI describes research techniques for economic damage issues, and offers a case study. In most valuation assignments, finding data to support a position is always challenging; finding inexpensive data is even more challenging. The book provides resources for hard-to-find databases such as royalty rates.

In general, the book is a must for the serious practitioner wanting to stay on the cutting edge. Certain controversial issues are addressed and clarified, and there are enlightening discussions on advanced topics. The book is intended to tell the reader what is happening now in the evolving field of business and intangible asset valuation. Although it was published in 2004, certain not-so-recent changes in the law are not reflected in the text. For example, the chapter by Pamela Garland refers to patent life of 20 years from issuance, but the law adopted in 2003 grants patent life for 20 years from application date. Therefore, caution is advised. The moving target of current law and thinking cannot be solidly cast in any work of this size and scope.

Nonetheless, *The Handbook of Business Valuation and Intellectual Property Analysis* is a welcome addition to my library. I recommend it to any serious valuation professional, as well as to those just entering the field.

Willamette Management Associates Insights

COMMUNIQUE

IN PRINT

Robert Reilly, firm managing director, authored an article that appeared in the Summer 2005 issue of *The Journal of Employee Ownership Law and Finance*. The title of Robert's article is "Valuation Adjustments in ESOP Employer Stock Valuations."

Robert Reilly also authored another article that appeared in the Summer 2005 issue of *The Journal of Employee Ownership Law and Finance*. The title of Robert's second article is "Procedures for Financial Advisers to Help ESOPs Avoid Overpaying in Acquisitions."

Robert Reilly co-authored a chapter in the recently revised edition of *ESOP Valuation*, a text published by the National Center for Employee Ownership in Oakland, California. The title of Robert's chapter is "ESOP Valuation and Financial Advisory Analysis Due Diligence Checklist."

IN PERSON

Robert Reilly addressed the 2005 Institute of Property Taxation Symposium in San Antonio, Texas. The title of Robert's presentation is "Is Obsolescence Obsolete? Procedures to Identify and Justify Obsolescence Allowances."

Robert Reilly gave a presentation at the Strategic Research Institute's 2nd Annual Intellectual Property Financing and Securitization Summit on September 26 and 27, 2005, in New York City. The topic of Robert's panel discussion was "A Review of Pharma & Drug Royalty IP Market Developments."

Bob Schweihs, firm managing director, gave a presentation at the Strategic Research Institute's 2nd Annual Intellectual Property Financing and Securitization Summit in New York City. The topic of Bob's panel discussion was "Brand Appraisals and Brand Valuation Approaches."

Curtis Kimball, Atlanta office director, will give two presentations at the American Institute of Certified Public Accountants/American Society of Appraisers National Business Valuation Joint Conference November 14 through 16, 2005, in Las Vegas, Nevada. On November 14, Curt will give a presentation on "Case Law Update." On November 15, Curt will give a presentation on "Ethics."

Daniel Van Vleet, Chicago office director, will also give a presentation at the American Institute of Certified Public Accountants/American Society of Appraisers National Business Valuation Joint Conference in Las Vegas. The topic of Dan's presentation on November 14 will be "The

Valuation of S Corporations and Other Pass-through Entities."

Charles Wilhoite, national director of health care financial advisory services, and Peter Ketchum, Atlanta office principal, will present the welcoming remarks at a reception at the Illinois Association of Healthcare Attorneys Annual Symposium on October 26, 2005, in Chicago. Willamette Management Associates is the sponsor of that reception.

Mike Hartman will present at The ESOP Association Two-Day ESOP Technical Conference in Las Vegas, Nevada, on November 10 and 11, 2005. The topic of Mike's presentation is "Recent ESOP Developments."

Alan Schachter, principal and director of our Westport, Connecticut, office, delivered a presentation to the Attorney Round Table in Garden City, Connecticut, on September 15, 2005. The topic of Alan's presentation was "Recent Developments in Cost Profits/Economic Damages Analyses Prepared for Litigation Purposes."

IN ENCOMIUM

Alan Schachter, principal and director of our Westport, Connecticut, office, has been appointed to serve as a member of the American Bar Association Family Law Section Committee.

David Chiang, Chicago office associate, and Chip Brown, Atlanta office associate, both passed the level II examination leading to the chartered financial analyst (CFA) designation. This designation is offered by the Institute of Chartered Financial Analysts.

At our firm's annual employee retreat, held in August this year at the O'Hare Hyatt Hotel in Chicago, we recognized the following Willamette Management Associates employee anniversaries:

<u>25 years</u>	<u>10 years</u>
Kathie Martin Portland office	Mary McCallister Chicago office
<u>15 years</u>	<u>5 years</u>
James Rabe Portland office	Adrian Loud Atlanta office
Charles Wilhoite Portland office	Tim Meinhart Chicago office
Daniel Van Vleet Chicago office	Stephanie Bowker Chicago office
	Kristine Taylor D.C. office