The McLean Group

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Valuation Vantage©

Insights and perspectives on leading corporate finance valuation issues.

Inside This Issue

IRS Issues Proposed Regulations Restricting Valuation Discounts for Family-Controlled Entities

On August 4, 2016, the IRS issued proposed regulations to restrict valuation discounts for estate, gift, and generation-skipping transfer taxes.

BACKGROUND

Internal Revenue Code ("IRC") 2704 originally provided special valuation rules for interests in family-controlled corporations and partnerships transferred for estate, gift and generation-skipping transfer tax purposes. The IRS allowed discounts if voting and/or liquidation rights were eliminated upon transfer. However, the IRS recently released new regulations that are based on a stricter interpretation of IRC 2704.

This may result in discounts for lack of control and lack of marketability being eliminated or reduced for family-controlled operating entities and not just family-controlled entities comprised of passive assets (such as stocks, bonds, and other marketable securities).

MAIN PROVISIONS OF PROPOSED REGULATIONS

The IRS proposed the following regulations to eliminate or reduce discounts for lack of control and lack of marketability for transferred ownership interests:

1. A restriction on the ability to liquidate an individual interest is not an applicable restriction.

continued

"IRS Issues Proposed Regulations..."

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2. Voting and liquidation restrictions in a family-controlled operating entity are disregarded in the absence of applicable state law.

3. A nonfamily member interest is disregarded if it is a less than 10% equity interest in a corporation. This would result in a family member interest that is close to 50% ownership being considered to have control in the corporation.

4. Nonfamily member interests, collectively, are disregarded if they are less than 20% of equity interests in a corporation. This would also result in a family member interest that is close to 50% ownership being considered to have control in the corporation.

5. A nonfamily member interest's lack of a put right is also disregarded as a liquidation restriction.

6. Liquidation rights are eliminated if transfers are performed more than three years before the decedent's death. This eliminates the incentive to make transfer ownership interests close to the decedent's death.

7. Any liquidation restrictions on interests in family controlled entities would be disregarded by the IRS if these restrictions lapse after these interests are transferred to family members.

KEY TAKEAWAYS

The proposed regulations are expected to receive extensive feedback. There is a public hearing on December 1st. In general, there is immense pushback regarding its argument that liquidation restrictions should be disregarded, which may result in significantly lower discounts. Many advisors are pushing their clients to complete any transfers before the new rules take place.

Simplifying Goodwill Impairment Accounting

On May 12, 2016, the FASB issued a proposed Accounting Standards Update ("ASU") under ASC 350 that allows all companies including public companies and non-profits to use a goodwill measurement alternative. Comments are required by July 11, 2016. The FASB will then take into consideration these comments in making any final changes before issuing the final ASU.

BACKGROUND

The FASB created this proposed ASU to simplify the goodwill impairment test process for all companies, except for private companies that already elected the private company alternative.[1]

MAIN PROVISIONS OF NEW PROPOSED ASU

The proposed ASU removes the requirement for a company to perform a Step 2 goodwill impairment test when it does not pass a Step 1 goodwill impairment test. A goodwill impairment test under the proposed ASU also has the following proposed changes:

1. A goodwill impairment test would involve comparing the fair value of a reporting unit with its carrying amount. An impairment charge would be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value. However, the impairment charge would never exceed the carrying amount.

2. A reporting unit with a zero or negative carrying amount would not be required to perform a qualitative test. Also, if it performs a qualitative test and fails, the reporting unit would not be required to perform a Step 2 goodwill impairment test.

3. A company would be required to disclose the existence of any reporting units with zero or negative carrying amounts. The goodwill amounts allocated to those reporting units would have to be disclosed.

A company still has the option to perform a qualitative assessment, or Step 0 test, to determine whether a quantitative impairment test, or Step 1 test, is necessary.

KEY TAKEAWAYS

The proposed ASU does not require a Step 2 goodwill impairment test, which will save time and costs for companies that fail a Step 1 test. Specifically, an analysis similar to a purchase price allocation would not need to be performed to determine an impairment charge which is currently required under step 2.

The effective date for the proposed ASU likely will be December 15, 2019 for public companies that file with the SEC and December 15, 2020 for public companies that do not file with the SEC. The FASB proposed specific transaction guidance for private companies that elected the private company alternative for subsequent goodwill accounting, but that have not adopted the private company alternative that combines certain intangible assets with goodwill.

[1] The private company alternative does not require the subsequent measurement of goodwill.

Clarifying the Definition of a Business

On November 23, 2015, the FASB issued a proposed Accounting Standards Update ("ASU") under ASC 805 that clarifies the definition of a business.

BACKGROUND

The current definition of a business is commonly critiqued as being too broad, resulting in many asset acquisitions falsely qualified as businesses. Analyzing transactions under the current definition is difficult and costly, and does not always permit the use of reasonable judgment.

MAIN PROVISIONS OF NEW PROPOSED ASU

As defined under the proposed ASU, a business is an integrated set of activities and assets capable of being conducted and managed to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members or participants. In other words, a business includes at a minimum an input and substantive process that together create outputs. The proposed ASU would remove the need to evaluate whether a market participant, such as a buyer or investor, could replace any missing elements of a business.

The three elements of a business are defined below:

1. Inputs - Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.

2. Process - Any system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to create outputs. Examples include strategic management processes, operational processes, and resource management processes. These processes typically are documented, but an organized workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs.

3. Output - The result of inputs and processes applied to those inputs that provide goods or services to customers, other revenues, or investment income, such as dividends or interest.

In addition to the new business definition, the proposed ASU addresses the following issues in ASC 805:

1. A set that does not have outputs - When a set does not have outputs (for example, an early stage company that has not generated revenues), the set would have both an input and a substantive process that together contribute to the ability to create outputs if it includes an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that, when applied to another acquired input or inputs, is critical to the ability to develop or convert that acquired input or inputs into outputs. An entity should consider the following in evaluating whether the acquired workforce is performing a substantive process:

    a. A process (or group of processes) is not critical if it is considered ancillary or minor in the context of all the processes required to create outputs.

    b. Inputs that the organized workforce could develop (or is developing) or convert into outputs could include the following:

        i. Intellectual property that could be used to develop a good or service

        ii. Resources that could be developed to create outputs

        iii. Access to necessary materials or rights that enable the creation of future outputs.

"Clarifying the Definition of a Business..."

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Examples could include technology, mineral interests, real estate, or in-process research and development.

2. A set that has outputs – When a set has outputs (that is there is a continuation of revenue before and after the transaction), the set would have both an input and a substantive process that together contribute to the ability to create outputs when any of the following are present:

    a. An organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs, is critical to the ability to continue producing outputs.

    b. The acquired process (or group of processes), when applied to an acquired input or inputs, contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

    c. The acquired process (or group of processes), when applied to an acquired input or inputs, contributes to the ability to continue producing outputs and is considered unique or scarce.

3. Assets that should not be considered part of a set - The following assets should not be combined into a single asset or considered similar assets:

    a. Tangible and intangible assets (for example, real estate and in-place lease intangibles).

    b. Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development), except for groups of identifiable intangible assets that are recognized and measured as a single identifiable asset such as complementary intangible assets that have similar useful lives.

    c. Financial and nonfinancial assets.

    d. Different major classes of financial assets (for example, cash, accounts receivable, and marketable securities).

    e. Different major classes of tangible nonfinancial assets (for example, inventory, manufacturing equipment, and automobiles) other than those that meet the criterion to be considered a single asset.

The proposed ASU provided the following examples of acquired sets of assets that would not be considered a business:

1. Set of single-family homes and the associated in-place leases
2. Drug compound used to treat a disease
3. Idled manufacturing facility
4. License of distribution rights

KEY TAKEAWAYS

The proposed ASU would be applied prospectively to any transaction that occurs after its effective date and may result in more transactions classified as asset acquisitions across all industries—especially the technology, oil and gas, real estate, and pharmaceutical industries.

NEXT STEPS

This proposed ASU is part of a larger FASB project that will:

1. Clarify the guidance for partial sales or transfers of assets.
2. Consider whether there are differences in the acquisition and de-recognition guidance for assets and businesses that could be aligned.

The effective date for the proposed ASU likely will be December 15, 2017 for public companies. For private companies, the effective dates will likely be December 15, 2018 and December 15, 2019, respectively, for annual and interim reporting periods. Early adoption is likely to be permitted after December 15, 2016 with specific exceptions for private companies.

Recent Changes to Market Participant Acquisition Premium Guidance

In November 2015, The Appraisal Foundation's Working Group on Control Premiums ("Working Group") issued an exposure draft on the measurement and application of market participant acquisition premiums ("MPAP") after receiving feedback pertaining to its discussion draft questions. The exposure draft provides a more defined framework to determine how and when to use control premiums as there is significant diversity in how control premiums currently are applied for goodwill impairment step 1 test purposes and other financial reporting purposes. In 2008, the SEC raised concerns that control premiums may be inflated by public companies to avoid goodwill impairments. The SEC requires justification when control premiums appear to be inflated.

The Working Group added to the exposure draft further discussion regarding the economic benefits to analyze in determining an MPAP. This includes possible economic benefits to analyze in determining a required rate of return/discount rate. In particular, the Working Group added the following concepts that valuation specialists may consider analyzing to reflect the appropriate market participant's perspective when estimating a size premium to build to a required rate of return/discount rate:

1. As a practical expedient, valuation specialists could bookend their income approach using the differing possible perspectives of market participant's risk to generate two valuation indications—one reflecting the target's size and another reflecting the combined entity's size. The valuation specialist selects a point within the range, taking into consideration the accounting standards requiring the analysis.

2. The valuation specialist may apply other valuation techniques under the market or cost approaches to reveal a point in a range where there is the greatest consensus across approaches thereby implying the stronger size premium case.

3. The valuation specialist may calibrate the risk measure by reviewing the accounting exercise (e.g. business combination valuation) that was recorded for the subject company.

4. The valuation specialist may calibrate the risk measure by reviewing the accounting exercise (e.g. business combination valuation) that was recorded for comparable companies.

In analyzing observed transaction premiums from public companies, the following factors to consider in determining an MPAP were added to the exposure draft:

1. Stated Rationale for Transaction - When available, analysts should review press releases and other corporate announcements describing the transaction to determine if the price paid (and therefore the multiples and premiums observed) reflects any buyer-specific synergies, or if any other characteristics of the transaction render it unsuitable for use in a fair value measurement.

2. Stock Price and Volume Fluctuations Prior to Announcement - In some cases, the stock of the target company may exhibit unusual volatility and/or increased trading volume prior to the formal announcement of the transaction. The existence of such phenomena may indicate that the implied acquisition premium should be calculated with reference to an earlier, unaffected stock price.

The Working Group also replaced its MPAP selection and assessment example with the following examples:

1. The first example addresses a case in which an MPAP is critical to the pass/fail result of the test.

2. The second example addresses the same company and basic fact pattern, but assumes a significantly lower carrying value, resulting in a test for which the MPAP is not a determining factor.

Both examples' tests are the same in terms of the main methods considered. However, the level of detail provided in support of MPAP-related assumptions in the second example is reduced to reflect the lack of MPAP significance in relationship to the test result. The final MPAP guidance is expected to be issued in early 2017.

The final guidance is expected to be issued within the next year.

The McLean Group

Dell Undervalued in Sale Process

In Re: Appraisal of Dell, Delaware Chancery Court, Civil Action No. 9322-VCL (May 31, 2016)

Dell Inc. ("Dell" the "Company," or the "Respondent") received written appraisal demands from certain Dell shareholders ("Petitioners") as a result of an allegedly low price for Dell's management buyout ("MBO").

BACKGROUND

In 2012, Dell began to make efforts to prove that its stock was worth more than the value determined by the stock market. In particular, the Respondent's CEO marketed the Company in the financial media in a "sum of the parts" manner. This was an attempt to get Dell's stock price closer to the level from the Company's internal valuations. However, this was not achieved since the Company was not able to meet its aggressive forecast expectations. As a result, the Company began entertaining the possibility of an MBO from private equity firms including Southeastern Asset Management ("Southeastern"), Silver Lake Partners ("Silver Lake"), and Kohlberg Kravis Roberts ("KKR"). The Company's board of directors then formed a special committee (the "Committee") to evaluate a potential transaction and other strategic alternatives. As part of this committee being formed, it hired JPMorgan as its financial advisor.

SALE PROCESS

JPMorgan performed a series of analyses including a discounted cash flow ("DCF") analysis based on Wall Street consensus and forecasts from September 2012 ("September Case") indicating a range of $15.25 to $19.25 per share and $20.00 to $27.00 per share, respectively. In October 2012, the Company hired Goldman Sachs to help it prepare for management presentations. As part of this process, Goldman Sachs determined a per share value of $16.00 based on the September Case.

Silver Lake and KKR then provided indications of interest ranging from $11.22 to $13.00 per share, but excluding the CEO's shares. Despite these indications showing premiums ranging from 20% to 40% above Dell's stock price, they were still well below the various DCF analyses performed by JPMorgan except for the DCF analysis based on the low Wall Street forecasts for the Company. Also, the internal rates of return ("IRR") implied by the indications of interest were well above 20%.

In November 2012, Wall Street equity research analysts indicated a per share value of $8.50, which was well below the indications of interest. As a result, this prompted the Committee to hire Boston Consulting Group ("BCG") as an independent advisor on the Company's forecasts. KKR then pulled out of the competition to acquire the Company, which prompted the Committee to reach out to other private equity firms. In early 2013, BCG prepared a base case forecast assuming $3.3 billion in cost savings from a proposed MBO. BCG then assessed the likelihood of the cost savings in its forecasts with 25% of savings realized ("BCG 25% Case") and 75% of savings realized ("BCG 75% Case"). BCG concluded that the BCG 25% Case was the most likely to occur given the Company's track record of cost-saving initiatives. In the meantime, the effort to reach out to other private equity firms yielded no additional offers.

Dell hired Evercore as a second financial advisor for a go-shop period. Evercore came up with a DCF valuation ranging from $14.27 to $18.40 per share. It also determined an LBO valuation ranging from $12.36 and $16.08 per share assuming a financial sponsor required an IRR between 15% and 25%. After a go-shop period that yielded no offers from potential strategic acquirers including HP, but two additional offers from financial sponsors, the deal was finalized with Silver Lake offering $13.75 per share for Dell's shares. JPMorgan and Evercore opined that the deal was fair from a financial point of view.

FINANCING FOR THE DEAL

In order to obtain debt financing for the deal, Dell and Silver Lake submitted a forecast to banks ("Bank Case"). The Bank Case was more optimistic than analyst reports or an International Data Corp. ("IDC") report on PC shipments in terms of the Company's expected growth. Also, the Bank Case assumed Dell's profit margins would increase over the next five years. After the debt financing was obtained, 70% of the Company's shareholders approved the deal. The deal then closed in late October 2013. Some shareholders of Dell not affiliated with the CEO ("unaffiliated shareholders") voted against the deal and filed for an appraisal in the Delaware Chancery Court (the "Court").

"Dell Undervalued in Sale Process"

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COURT'S CRITIQUE OF THE SALE PROCESS

The Court found Dell's sale process to be flawed for the following reasons:

1. The Committee only engaged with financial sponsors in the pre-signing phase.

2. There was limited competition from potential bidders in the pre-signing phase.

3. The Company conceded that an LBO model is not "oriented toward solving for enterprise value."

4. An LBO model can be used to predict with a high degree of accuracy the range of offers that a target corporation can expect from financial sponsors.

5. An LBO model solves for an IRR and not present value, so it is not indicative of fair value. The goal of Silver Lake in using an LBO model was to achieve an IRR of 20% or more. Also, Silver Lake limited the amount of leverage that could be used in the deal.

6. Since the sale process depended on the willingness of financial sponsors to sacrifice potential IRR to win the deal, it was not indicative of intrinsic value.

7. The Committee did not seek to determine a pre- merger going concern value for the Common Stock to determine the fairness of the merger consideration to the Company's unaffiliated stockholders.

8. The Committee did not take into account valuation adjustments that should have been made for a depressed market for Dell's stock. This is especially the case since Dell made significant long-term investments that were not being recognized by the market in the short-term.

9. The go-shop period only resulted in proposed MBOs from financial sponsors.

10. The CEO's decision to have a 75% equity stake in the Company post-close meant any price above $15.73 per share would mean the CEO would lose control of the Company. This assumes that the CEO would not contribute additional equity. Therefore, any offer price above $15.73 per share would be very difficult to achieve unless the CEO was willing to give up the opportunity to have a 75% stake in the Company.

EXPERTS' VALUATIONS

The Petitioners' expert determined Dell's per share value to be $28.61. However, the Court did not find this per share value to be credible. The Court came to this conclusion since strategic companies in Dell's industry would have implied the Company could be purchased at a great value given its stock price was $9.35 at the time indications of interest were first given. In contrast, the Respondent's expert determined Dell's per share value to be $12.68.

Both the Petitioners' expert and Respondents' expert considered the BCG 25% Case forecast to be reliable. Also, the Court noted that BCG was a third party. However, the Respondent's expert then adjusted this case to account for the Company's failure to meet its forecast. In the process, the Respondents' expert used a current PC sales forecast from IDC to determine this adjustment. Although the Court typically does not approve litigation-driven adjustments to management projections, the Respondent's expert adjustments were considered by the Court to be reliable. The Petitioners' expert's use of the BCG 75% Case forecast were not considered to be reliable. The Court approved the both experts' use of the Bank Case forecast since it was nearest to the closing date of the MBO. The Respondent's expert's version of the Bank Case forecast was considered to be more reliable since it accounted for non-recurring restructuring expenses and stock-based compensation. The Court decided to equally weight the Respondent's expert's adjusted BCG 25% Case forecast, which was slightly conservative and the Respondent's expert's adjusted Bank Case forecast, which was slightly optimistic in determining Dell's DCF valuation.

"Dell Undervalued in Sale Process"

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In the DCF valuation, the Petitioners' and Respondents' experts used terminal year growth rates 1% and 2% respectively. The Court used 3% for the terminal year growth rate since it considered the rate of inflation to be the floor for terminal year growth rates.

For the tax rate applied in his DCF valuation, the Petitioners' expert used 21%, which was consistent with the September Case and valuation models prepared by the Company's financial advisors. The Respondent's expert used a 17.8% tax rate during the projection periods and 35.8% tax rate for the terminal period. The Court agreed with the Petitioners' expert use of a 21% tax rate since effective tax rates ranged from 16.5% to 29.2% in the five years up to the MBO. During the same period, cash tax rates ranged from 9.6% to 24.1%.

Also, the Company planned to indefinitely reinvest its earnings in foreign countries rather than reinvesting its foreign earnings domestically.

THE COURT'S CONCLUSION

The Court concluded that the Committee did not breach its fiduciary duty. However, the Court found the final merger consideration to be well below fair value. The Court equally weighted the DCF analyses based on the Respondent's expert's adjusted BCG 25% Case forecast and the Respondent's expert's adjusted Bank Case forecast. The first DCF analysis resulted in a per share value of $16.43. The second DCF analysis resulted in a per share value if $18.81. Based on equal weighting the DCF analyses, the Court determined a fair value for Dell's stock of $17.62 per share.

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Practice Highlights

Executive Leaders Radio

On **SEPTEMBER 25, 2016**, Andy Smith's interview on Executive Leaders Radio—the #1 business weekly radio show in the Mid-Atlantic—aired locally in DC, Virginia and Maryland on Federal News Radio and nationally on BizTalkRadio. The weekly program features four presidents, chairmen, or CEOs who share their success stories along with the challenges and opportunities ahead for their businesses and served industries.

GEORGE MASON UNIVERSITY

On **OCTOBER 17, 2016**, The McLean Group's principals Joe Golden and Andy Smith provided a valuation-centric presentation to George Mason University students enrolled in the "Building GovCon Acumen" program designed to prepare mid-level and rising executives to lead their companies into the future. This high-intensity program equipped participants for the "new reality" that is the government's adoption of cloud computing, the emergence of a mobile workforce, the spread of "Big Data," and the continued pressure to reduce costs. The convergence of these changes is creating a new era in government contracting — one that is disrupting the industry and challenging established players. Preparing for this "new reality" is a top priority for companies across the GovCon industry.

Caplin & Drysdale

On **OCTOBER 19, 2016**, The McLean Group's Andy Smith and Caplin & Drysdale's William Klimon held a breakfast seminar titled "M&A Issues for Non-Profit Organizations" for CFOs, CEOs, and board members at a broad range of nonprofit organizations. The event focused on the issues that nonprofit organizations face when undertaking mergers and acquisitions and how mergers and acquisitions can be a powerful growth tool to increase funding, expand community impact, extend services to new geographies and populations, and improve operational efficiencies.

The McLean Valuation Services Group

Through a dedicated business valuation practice, we provide a comprehensive offering of objective and defensible business valuation services, including financial security and intangible asset valuations for a variety of transaction, financial reporting, and tax purposes. We advise boards of directors, investors, trustees, and other corporate leaders on a range of transactions, including fairness opinions, valuation opinions for equity inventive plans such as ESOPs, estate and gift tax valuations, intangible asset valuations, and litigation support. Our valuations help clients fulfill their fiduciary duties, meet financial reporting requirements, determine corporate value, and mitigate risk.