

# Valuation Vantage<sup>®</sup>

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Insights and perspectives on leading corporate finance valuation issues.

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## Business Valuations Minimize Section 409A Risk: Beware of the Low Hanging Fruit in M&A Due Diligence

*As published in ACG National Capital Chapter's blog "Corporate Growth, Capital Style." Authored by The McLean Group's Andy Smith.*

Finally! You are in due diligence.

You weren't 100% sure if you could find a buyer, much less a sales price that would meet your and your investors' expectations.

*continued*

## “Business Valuations Minimize Section 409A Risk...” *continued*

But, the Letter of Intent is signed and you hope to be 60 days from closing – the team is already discussing the closing dinner plans. All you have to do is get the transaction “papered” and complete “confirmatory” due diligence.

Bankers and sell-side representatives love calling it “confirmatory” due diligence. “You have all the information that you needed to make an offer, and everything in the Information Memorandum is correct, so just confirm it and we are done!” If it were only that easy.

The due diligence lists are long, the data room is getting populated and the initial meetings are positive. Everyone is feeling good, as it always starts off on a positive note.

Typically, a young associate who is working through a standard due diligence asks the question, “In reviewing your compliance with Section 409A, do you have a business valuation to support the fair market value of the strike price of the stock options?”

The general counsel likely has no idea so he pushes the question down the hall for the CFO to answer.

Section 409A is part of the American Jobs Creation Act of 2004. This piece of legislation covers a broad definition of deferred compensation, and stock options are a principal type of deferred compensation. Section 409A was enacted in part due to the abuses at Enron and MCI/WorldCom. It was originally announced in October 2004, effective January 2005, but was postponed, eventually not being fully effective until 2009.

In many ways, it was really a good housekeeping measure. The IRS did not want companies fabricating low values for its stock option grants and wanted something to support the valuations (the IRS knew it needed to catch up to the SEC which was strengthening its focus on valuation issues for financial reporting).

Ironically, the higher strike prices for the stock options probably result in lower tax revenue since the ultimate capital gain is lower.

Issues like this provide buyers leverage during due diligence and help swing the pendulum their way as they finalize terms, and even consider re-trading the value. And, that simple band-aid solution, where the CFO makes a quick excel spreadsheet, hopefully it works, but per the IRS:

“The valuation of stock based upon a reasonable application of a reasonable valuation method is treated as reflecting the fair market value of the stock.”

*continued*

## “Business Valuations Minimize Section 409A Risk...” continued

Further, the CFO and business owner should be comfortable answering and supporting the following questions:

- Has the company estimated the Fair Market Value of the company’s stock in accordance with IRS definitions?
- Has the company selected a reasonable valuation method?
- Has the company reasonably applied the methodology?
- Has the valuation been performed by a qualified appraiser?
- What will the buyer think? What will the buyer’s due diligence team think?

Many private companies do not believe they need annual valuations. “We are too small, we are never going public, there is just a handful of us, it is too expensive.” Yes, you may never have plans to go public, but if you think you may ever be sold – you definitely need annual valuations.

The IRS exam risk may feel low (even though the IRS has trained hundreds of staff to identify valuation issues), but it is low hanging fruit for an M&A due diligence team to dive into. The severity of non-compliance penalties is one more deterrent to closing a deal. All amounts deferred can become immediately taxable, plus a 20% penalty tax.

If a business is granting stock options, it is mature enough to realize the fiduciary and compliance issues it faces. Our smartest clients embrace the annual valuation process, they make it part of their strategic planning process and they do not view it as part of the annual audit process or a compliance nuisance. They want another perspective on their value, and they want to learn about the market. A 409A valuation is not just a good housekeeping practice; an annual valuation can provide much more to a business—it can be a strategic planning tool, and it is required by law. ♦



# DCF Analysis Supports Transaction Value

*In Re Appraisal of Ancestry.com, Inc., Delaware Chancery Court, Civil Action No. 8173-VCG (January 30, 2015)*

Ancestry.com (“Ancestry,” the “Company,” or the “Respondent”) received written appraisal demands from several plaintiffs including Merion Capital, Merlin Partners, and The Ancora Merger Arbitrage Fund (“Petitioners”) as a result of allegedly inadequate offers for the Company by Permira Advisors (“Permira”).

## Background

Ancestry.com began an auction process in May 2012 to sell the Company after receiving unsolicited offers from private equity firms in early 2012. The Respondent received three offers during the auction process, including one from Permira, which ranged from \$30 per share to \$38 per share.

Ultimately, Permira made a final offer of \$32 per share in October 2012 after a partnership with another bidder to purchase the Company failed. The offer represented a 41% premium over the Company’s unaffected stock price.<sup>1</sup> The Petitioners sued for an appraisal after Ancestry.com’s board and shareholders approved the offer.

## Experts’ Valuations

The Petitioners, collectively, and Respondent each hired a valuation expert. The experts relied solely on the DCF methodology to value the Company as they were unable to find acquired companies or publicly traded companies comparable to Ancestry.

The Court disagreed with the Petitioners’ expert’s DCF analysis that used the Company’s May 2012 projections, which resulted in a higher merger price of \$42.81 per share.

The Court relied on the October 2012 projections for its DCF analysis, which also were used in the Respondent expert’s DCF analysis, despite the fact that they were not contemporaneous like the May 2012 projections. The Court felt that the October 2012 projections “represented management’s best view of the Company.” Also, both the Respondent’s expert’s and the Court’s DCF analyses were weighted equally. The Court’s DCF analysis resulted in a price of \$31.79 per share versus \$30.63 per share determined by the Respondent’s expert.<sup>2</sup>

## The Court’s Conclusion

The Court concluded that the merger price of \$32 per share offered by Permira represented Fair Value as the auction process that resulted in this merger price was robust and the DCF analysis that the Court performed provided “comfort that no undetected factor skewed the sales process.” ♦

<sup>1</sup> Unaffected stock price refers to the stock price excluding the effects of an auction process.

<sup>2</sup> The Respondent’s expert emphasized that the calculated range from their DCF analysis was within the \$32 per share merger price despite their opinion of a \$30.63 per share value.

# Internal Valuations Ordered to be Produced in Discovery as a Result of Petitioners' Pursuit of Appraisal

*In Re Appraisal of Dole Food Company, Inc., Delaware Chancery Court, Civil Action No. 9079-VCG (December 9, 2014)*

Hudson Bay Master Fund and Hudson Bay Merger Arbitrage Opportunities Master Fund ("Hudson Bay"), and Ripe Holdings (collectively "Petitioners") pursued an appraisal of their common shares after Dole Food Company, Inc. (the "Respondent" or the "Company") was taken private.

## Background

After the Respondent received an offer to be acquired and shortly before the merger closed, the Petitioners purchased shares of the Company. The Petitioners filed for appraisals of their shares after the merger closed.

After these petitions were filed and during discovery, the Respondent found that Hudson Bay applied the discounted cash flow ("DCF"), comparable company, and sum of the parts methodologies to value the Company prior to the merger. Ripe Holdings only used a DCF analysis.

Based on these findings, the Respondent requested the pre-litigation materials related to these valuations be produced in discovery by the Petitioners.

## The Court's Conclusion

The Court ordered that the pre-litigation materials related to the internal valuations that were used by the Petitioners be produced in discovery for the following reasons:

1. Several Delaware Chancery Court decisions have ordered production of pre-suit valuation material prepared by appraisal petitioners.

2. Pre-litigation valuations are relevant to the value of the subject company which is the main issue of this case's appraisal petitions.
3. Pre-litigation valuations may help determine if the appropriate inputs and considerations for valuation methodologies were used.
4. Pre-litigation valuations may bear on a witness' credibility including if a petitioner or its expert advances positions in litigation that differ materially from the petitioner's pre-litigation views. ♦

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## The McLean Group

The McLean Group provides M&A, business valuation and strategic consulting services to middle market businesses.

# Practice Highlights



Solutions Quarterly Learning Series in Dallas, TX.

On June 16, 2015, The McLean Group's Andy Smith presented, "Best Practices in Fair Value Accounting for Financial Reporting" at the Accretive



## Virginia Society of Certified Public Accountants

Virginia Society of CPAs. CPE credits will be granted to participants. Registration details to follow.

Mr. Smith will conduct this presentation again via webinar on February 5, 2016 through the



Andy Smith discusses how business valuations minimize the risk of Section 409A penalty taxes and warns executives about how they can be low hanging fruit in M&A due diligence. The full article may be found beginning on the front page of this publication.

In a contributed article on ACG National Capital Chapter's blog, "Corporate Growth, Capital Style," The McLean Group's

## The McLean Valuation Services Group

As a core competency and complement to our M&A practice, The McLean Valuation Services Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes. The McLean Valuation Services Group has the requisite experience and credentials to support litigation proceedings, including quantifying economic damages and valuing business interests.