

Too many adjustments compromise Deloitte's valuation

In re Coram Healthcare Corp., 2004 Bankr. LEXIS 1516 (October 5, 2004). Judge Walrath.

The relevant valuation issue in this bankruptcy matter, in which the court confirmed the trustee's modified plan, was the value of **Coram Healthcare Corp.** and **Coram, Inc.** (the "Debtors"), which would determine whether the trustee's plan was "fair and equitable."

Valuation evidence

Both parties provided expert testimony during trial and used the same methodologies: comparable public company analysis; comparable transaction analysis; and discounted cash flow analysis. However, as one might expect, their respective conclusions diverged substantially.

The court noted the key distinctions: "**Deloitte** [for equity committee] and **EB/SSG** [for trustee] included different assets in reaching their valuation conclusions, attached different weights to the three valuation methodologies, and took different positions regarding management's projections."

Did appraisers incorrectly rely on conservative, erroneous projections?

The equity committee argued that EB/SSG artificially deflated Debtors' value by relying on management's conservative projections. The equity committee argued that these projections were incorrect because they were not based on historical or industrial experience and the cash flow projections contained errors that resulted in a low discounted cash flow.

Additionally, EB/SSG did not conduct an independent review as to whether the projections were consistent with market projections or debtor's actual performance. EB/SSG's valuation was also criticized by the equity committee because their valuation methodologies varied from traditional methodologies as a result of their disregarding multiples that produced results that fell outside of their preconceived conclusions about the market. EB/SSG's valuation resulted in a going concern value of \$220 million.

Too many upward adjustments by Deloitte?

Deloitte's valuation utilized the "upside projections" prepared by EB/SSG. Deloitte adjusted EBITDA for charges that they did not consider to be regular. In addition to making adjustments to EBITDA, Deloitte made significant adjustments to growth projections, cash flow projections and management's established reserves. Deloitte determined that higher multiples were proper because Debtors' value contained a "significant 'specialty pharmaceutical' component." Deloitte finally concluded that the going concern value of Debtors was \$279 million.



The trustee criticized Deloitte's valuation for numerous adjustments to management's projections and the utilization of inflated multiples. In addition, the trustee argued that Deloitte's characterization of the company as a specialty pharmaceutical company was inaccurate and that Deloitte's inflated projections did not take into account the "price pressures" inherent in the industry. The trustee also argued that the increase of the EBITDA by 40%, due to the multiple adjustments made by Deloitte, was improper.

Holding and rationale

The Bankruptcy Court discussed the motivation for the difference in valuations, "[W]e recognize each side's incentives to either overvalue or undervalue the Debtors." However, the court noted there are limits, "Although valuations are subjective, there are proper and improper methods of performing a valuation."

The court held, "After our review of the evidence, we cannot conclude that EB/SSG strayed from generally accepted valuation methodologies. While we agree that their numerical inputs ... may have been conservative, the evidence does not establish that EB/SSG made inappropriate downward adjustments ... Accordingly, we do not find that the EB/SSG valuation is improper."

"After considering the competing valuations, the competing incentives of the parties, and the divergent evidence offered in support of the valuations we conclude that the value of the Debtors is less than \$ 317 million." In a footnote, the court noted that "This figure is calculated by adding the going concern value of \$ 220 million determined by EB/SSG, the \$ 31.2 million in cash on hand, the \$ 10 million in present value of the NOLs, and the value of the claims being released (less than \$ 56 million)."

In addition, the Bankruptcy Court noted why Deloitte's valuation was not adopted: "Deloitte took aggressive and optimistic views regarding the valuation and strength of the Debtors. Therefore, we do not find that the Deloitte valuation is an accurate reflection of the Debtors' value." The court adopted the valuation of EB/SSG and valued the debtor at \$220 million.

Appraisal does not equal arbitration

Salt Lake Tribune v. Management Planning Company, 2004 U.S. App. LEXIS 24701(10th Cir. November 30, 2004). Judge Lucero.

The issue in this case was whether a purchase agreement calling for an appraisal could be labeled an arbitration and thus avoid judicial review. Applying federal law, the court held that in this case the agreement for an appraisal did not amount to an arbitration, because it would not definitively settle a dispute between the contracting parties, and, therefore, the court reversed the district court's ruling.

Higher book value selected

Heyne v. Heyne, 2004 Iowa App. LEXIS 1308 (December 8, 2004). Judge Huitink.

The issue in this marital dissolution was the value of **Walnut Telephone Company** stock owned by husband.

Valuation evidence

The accuracy of what the two proposed values represented was undisputed. Husband argued that the proper value of the

EXHIBIT I	
Retained earnings	\$9,500,000
Current assets	\$1,298,000
Non-current assets	\$5,347,000
Plant and equipment	\$3,178,000
Number of outstanding shares	14,020

stock was \$150 a share, which was the price for the company's stock per the first refusal set out in its by-laws.

Wife argued that the book value of \$700 a share was the more appropriate value because it best reflected the actual value of the stock. The company did have significant retained earnings and other assets (see *Exhibit 1*). Husband agreed that the book value was \$700, but disagreed it better represented the fair market value.

Holding and rationale

The court held that the \$150 a share figure proposed by the husband was "grossly underpriced." The court did note that book value was not the only legitimate method of valuation. However, the court of appeals adopted the trial court's use of the book value as the value of the stock.

The court also noted that because of husband's position (president and chairman) in the company, he could authorize the purchase of stock to match any offered price.

Economic Outlook — Fourth Quarter 2004

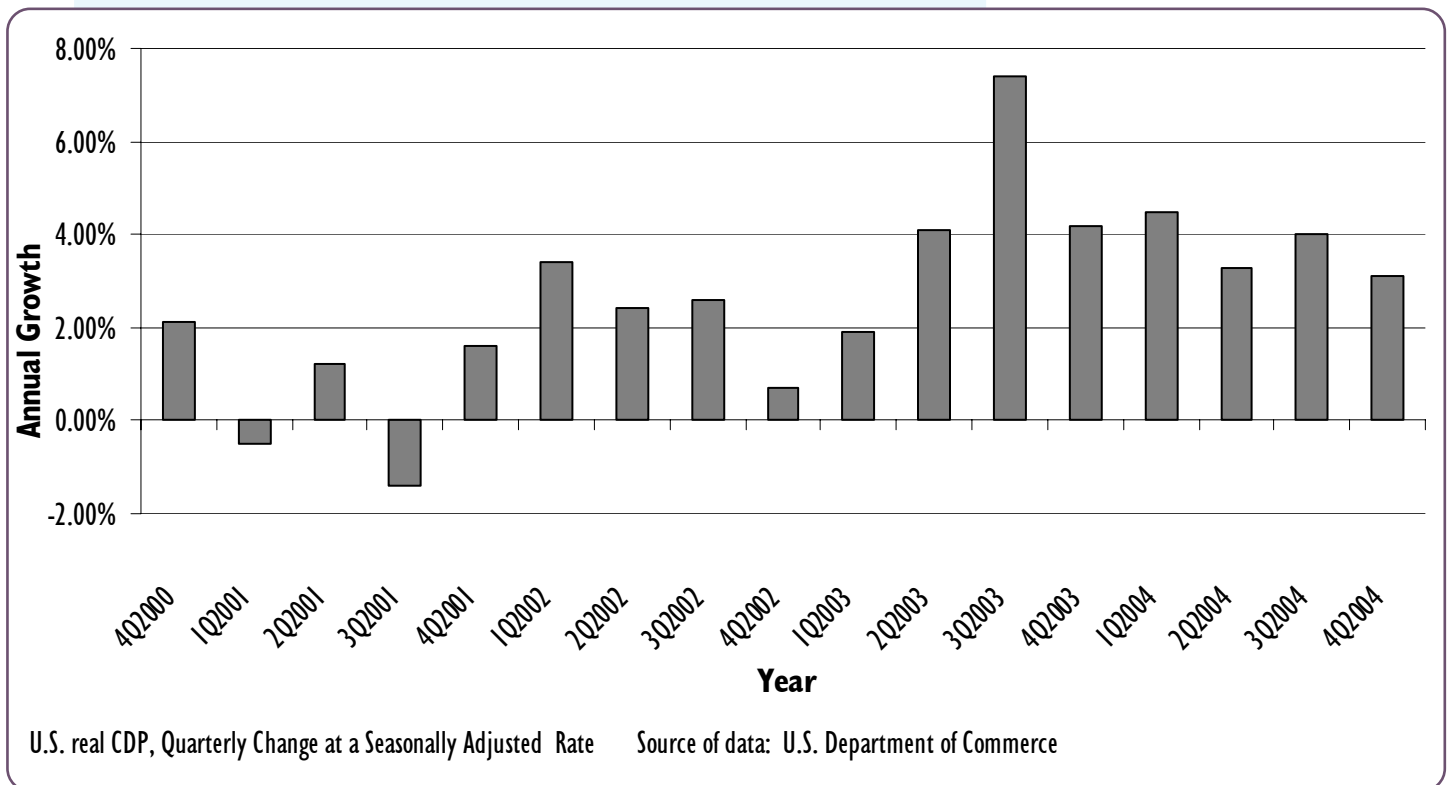
General economic conditions

The U.S. economy, which was hampered by the growing trade deficit, slowed during the fourth quarter of 2004. Besides growing at a slower rate than the previous quarter, the gross domestic product (GDP), which is the broadest measure of the economy's health, posted a less-than-expected fourth quarter figure. Although, the fourth quarter showing was somewhat disappointing, the economy expanded at its fastest pace in five years in 2004, boosted by strong consumer and corporate spending.

Gross domestic product

The U.S. Department of Commerce reported that the nation's economy increased at an annual rate of 3.1 percent in the fourth quarter of 2004, as indicated by the GDP, and is down from the 4.0 percent rate that was posted in the third quarter, as can be seen in *Exhibit 1*. In 2004, the economy grew by 4.4 percent, compared to an increase of 3.0 percent in 2003 and 1.9 percent in 2002. The 2004 growth rate, which reflected strong consumer spending, was the fastest rate since a 4.5 percent increase in 1999. The acceleration in fourth quarter GDP growth reflected an increase in consumer spending and private inventory investment, but was offset by the downturn in the exports of goods and the increase in imports.

EXHIBIT I: Real Gross Domestic Product 4Q 2000-4Q 2004



IPOs do not generally create liquidity opportunity —DLOM still valid for controlling interests

The Willamette Management Associates Failed IPO Study: Does a DLOM Apply to Controlling Ownership Interests?, Gregg S. Gaffen, *Insights*, Autumn 2004, pp. 52-54.

Valuation analysts often overlook applying a discount for lack of marketability to controlling interests in a privately held firm. The IRS believes that this discount should not be applied, and many cite the reason that an owner with a controlling interest can pursue an IPO, which creates liquidity for the shares. To test this hypothesis, **Willamette Management Associates** conducted what they called the *Failed IPO Study*.

This study compares the number of companies that filed an IPO registration with the SEC to the number of companies that successfully completed their IPO. The study is based on quarterly stock market data from 1990 through 2002. The study also analyzes successfully completed IPOs in which the subject stock is no longer publicly traded.

The study was performed to gain insight into the likelihood of a privately held company successfully completing an IPO, and

to determine if some level of DLOM should be applied to valuing controlling ownership blocks in a closely held company.

The results of the study show that, even once registration is completed and filed with the SEC, successful completion of an IPO is highly uncertain: many companies never make it through the registration process. The study also shows that, even if a firm successfully completed its IPO, it took an average of three months to achieve share liquidity after the IPO registration filing date.

Furthermore, the investment banking fees related to the IPO are typically 7.5% of the initial market capitalization. In addition, other professional fees and costs were incurred during the IPO process. So, even successful owners who completed the IPO process can experience illiquidity from an uncertain IPO stock price, significant transaction costs, and a significant time lag to achieve amortization.

This information leads to the conclusion that controlling ownership interests in closely held companies should not be valued as if readily marketable.

Inflation is only a small part of appreciation

Active versus Passive Appreciation—The Same Old Inflation Argument—But Is It Valid?, George B. Hawkins, *Business Valuation Alert*, April 2004, pp. 9-10.

In marital dissolution cases, often the division of the appreciation in value of a spouse-owned business depends on whether the increase in value between the date of marriage and the date of divorce resulted from active efforts by a spouse or from passive external forces.

Where the appreciation is attributable to active efforts, it is considered marital property, subject to division. If, on the other hand, the appreciation is attributable to passive forces, such as inflation, the property is considered separate property and is not subject to division.

A typical argument made by the spouse desiring to exclude the increased value from marital property is that the appreciation can be accounted for exclusively by inflation.

This article asserts that the logic of this argument is flawed and is not supported by research. If there were truly a direct, dollar-for-dollar correlation between inflation and company value, investors would get a guaranteed return on their initial investment that was at least as great as inflation; management would be irrelevant; a business's degree of leverage would have no impact; the condition of its assets wouldn't matter, etc.

According to the article, the inflation argument is a fallacious myth, and therefore, the next time you are on the other side of it in a divorce case, you should encourage your attorney to challenge it.

Including sales and profits in a divorce valuation

Q: Is it appropriate to include future sales and profits attributable to the personal goodwill of one spouse in a divorce valuation?

—Anonymous

A: The answer to your question is clearly dependent upon the specifics of the state in which the divorce occurs. Some states attempt to cleanly separate goodwill into enterprise goodwill and personal goodwill. Others make no distinction between personal goodwill and enterprise goodwill. It is absolutely imperative to get a clear definition of the law from the attorney you are working with. The attorney should support that definition by providing you with statute citations and effective case law precedents that provide the boundaries of the definition of personal goodwill in the jurisdiction. Don't rely on textbooks or word-of-mouth to guide you; the responsibility for the definition of the law lies with counsel, not the appraiser.

The question, where personal goodwill must be excluded from

the valuation, is the method for doing so. Each jurisdiction will have its own list of factors for consideration. An example (California's) is cited in *PPC's Guide to Business Valuations*. Jim Hitchner has a good section on personal goodwill in his *Financial Valuation – Applications and Models* book.

In considering a specific case, however, I would start with Statement of Financial Accounting Standards No. 141. While this statement was designed to facilitate the identification and valuation of intangible assets in the context of corporate acquisitions, the concepts can be used in the identification of intangible assets in a divorce situation. It is all too easy, in looking at a small business or professional practice, to lump all intangibles into the "goodwill" category. By identifying specific components of intangible value, the value of goodwill can be whittled down, possibly to the point where it might all be "personal" because the specific identification process will have eliminated the other elements which are more closely tied to the business or professional practice.

—Jim Lurie, CPA/ABV, CBA, CVA, BVAL, CIRA

Technology sector valuations

CyberValuation 2004, Bond & Pecaro, Inc. 2004. 1920 N Street, N.W., Suite 350, Washington, DC 20036. Phone: (202) 775-8870, Email: BP@BondPecaro.com, Web site: www.CyberValuation.com. \$395, 199 pp., 8½" x 11", softcover.

A product of **Bond and Pecaro, Inc.**, *CyberValuation* analyzes the value of technology businesses by presenting relevant data on notable transactions. B&P focuses on the key components of the transactions in an attempt to develop a collection of practical measures of value.

CyberValuation offers analysis and valuation multiple data that is intended to be useful in the valuation of businesses within the technology sector. Where available, B&P includes data regarding the purchase and sale of technology businesses and initial public offerings.

For public transactions, information is provided on the purchase price, offering proceeds or market capitalization, and revenues of the business. In some cases, the structure of a given transaction is documented. Many of the listed transactions occurred between closely held companies, and the parties chose not to disclose full transaction details. The



data was thus gathered through surveys of online research, print media, trade press, SEC filings, and company Web sites.

This book examines 1,040 technology company transactions that were announced or closed within 2003, and captures transactions in the areas of Internet Service Providers/Portals, Business-to-Consumer, Business-to-Business, Infrastructure, and Telecommunications. Each area is divided into its own section and contains an industry overview, market overview, operating trends, industry-specific transactions with valuation multiples, and a B&P industry index with valuation multiples.

In addition, the book overviews the U.S. economy and tech-consumers. Apparently, a record number of Americans are using the World Wide Web, an estimated 186.5 million in 2003, and spending more time online, with households averaging 27 hours per month. Also, demand for broadband has grown among residential users, from 39.0 million in May 2003 to 49.5 million in November 2003.

Whether you're a CFO, a shareholder, or a business valuer this book can prove valuable for gathering sector, transaction, and market-specific data for entities within the technology industry.

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