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# Firm Values

## A Business Appraisal Publication

Presented By:

GRW APPRAISAL SERVICES

BUSINESS APPRAISAL AND LITIGATION SUPPORT SERVICES

I provide this Firm Values newsletter to offer insight into current information on trends in business and the appraisal industry. I hope you find it useful and welcome any of your questions or comments. If there is a topic you'd like me to discuss or report upon please let me know. If this is your first time reading this newsletter, welcome aboard and thanks for your interest.

Greg Weichbrodt
Principal

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This edition of Firm Values presents a discussion of the merits of writing a cohesive company story in a valuation report, a home healthcare industry focus, and a discussion about a Minnesota Supreme Court ruling concerning earnout payments.

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## A Company's Story

When reading a business valuation report, naturally many people focus on the valuation conclusion and the mechanics of calculating it. After all, most often the purpose of engaging a valuation expert is to receive an expert's opinion of company value. A valuator inspects and presents company financials and applies one or more valuation approaches to arrive at a conclusion of value. However, without fully understanding and considering a company's path to present (and future) operations, a value conclusion may be worthless.

Any one with a little business and financial knowledge can quickly perform value calculations by utilizing industry rules of thumb, such as multiples of annual sales or earnings. Whether true or not, it is said accounting firms are worth 1 times annual revenues. Writing that sounds uniformed, at best. Experienced valuation professionals apply tested valuation approaches that are based on observed market data, and just as or more importantly, the consideration of a company's story. Valuation is an iterative process wherein after inspecting company financial information, the valuator attempts to create a narrative of his/her understanding of the business. Then, a good valuator considers whether the story makes sense, or seems to be missing some previously overlooked or misunderstood aspect of the business. The valuator will again look at the numbers to confirm that the story is cohesive and, only then, settle on an informed opinion of value, or repeat the analysis and story telling process until it is so.

Recently, I was asked to value a printing shop. I'll call it Print-it. Surely, this would be an easy task. In the printing industry there is a considerable amount of comparative financial information from which I could gauge the strength of company operations. Sales of similar companies would guide me to reasonable pricing multiples. I'd just have to plug in the company's numbers and start the presses. No problem, right?

Management provided company financial statements for several years of operation. The company was in business for over 20 years and until the most recent year, reported generally stable revenues and earnings. Recently, revenues had declined somewhat and earnings declined considerably. On the surface, and after a discussion with management, it appeared that normal economic conditions may have caused revenues to decline, and that expenses were not reduced quickly enough for the company to maintain historical operating margins. Management stated that they did not want to fire employees only to have to hire replacements when the economy righted itself.

So I began to look at cash flows and develop pricing multiples to apply to Print-it. The company operated at profit margins that were somewhat below industry norms, and based on an initial inspection of the financials, I started to form an opinion about company value. Since the most recent period seemed like an anomaly, I would consider it in my analysis but place more reliance upon the results of operations from the preceding years. As I was telling the story of lower historical profit margins and recent poor performance, I didn't observe the same downward operating trend in other print shops. As a result, I questioned my preliminary conclusions.

A closer look at the financials revealed elevated expenses for items that just didn't make sense. Inflated labor, excessive tool purchases, and high equipment costs stood out. As it turned out, the company had been diverting time from its primary business by investing in a large mobile printing machine and expensing all project costs as incurred while not yet receiving any revenues from this new line of business. Once the mobile print machine was operational, the company anticipated the elimination of ongoing machine building costs, and increased revenues. That made sense. However, from an analytical perspective, I had to make a choice. I could either: 1) consider the previously incurred project costs and have management map out a planned revenue stream for the new line of business, if possible, or 2) if the project appeared too speculative, I could make an adjustment to the historical financials to remove all machine building project expenses and ignore the new venture's effect on profitability.

Ultimately, in the report, I isolated project costs and wrote about the company's endeavors. A choice was made to exclude the project costs and potential incremental revenues since it was not possible to confidently predict the project's effect on business. I discussed how it was likely that diverting attention from the company's primary focus lead to a reduction in sales and that without such a diversion, the company may operate similar to its peers. I proceeded to apply pricing multiples that were deemed appropriate and arrived at a conclusion of value.

Ultimately, things aren't always immediately crystal clear and may never be. However, the process of describing in text a company's activities and operating performance while developing an opinion of value likely will make for a more rigorous valuation analysis than if first arriving at a conclusion of value and then writing the company's story. In addition, by writing a cohesive e story about a company a client may find the analysis and findings of the valuation report useful for guiding their business in coming years. When used as a business roadmap, the valuation report and company story may help management make decisions to improve revenue, lower costs, and boost enterprise value.

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## An Industry to Watch

Home health and hospice M&A activity soars. For three quarters in a row, there have been at least 20 publicly announced acquisitions of home health or hospice companies, a much higher quarterly volume than during most of 2017, according to new data from HealthCareMandA.com (Irving Levin Associates).

Private equity-backed home health companies were the most prolific buyers in the third quarter. During a recent Business Valuation Review, BVR webinar, healthcare valuation experts Darcy Devine (BuckheadFMV) and Will Hamilton (Veralon) explained that hospice firms (that also often include home health) enjoy operating margins of 8% to 9% compared to the smaller margins of most other healthcare entities, which makes them attractive M&A targets.

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# Contentious Ruling from Minnesota High Court on Dealing with Earnout Payments in Divorce

In an important ruling, a divided Minnesota Supreme Court recently ruled on whether earnout payments related to the sale of the husband's interest in a lucrative company were a marital asset.

The dispute involved Talenti, a gelato and sorbet producer (offering 43 flavors as of this date). The husband indirectly held an interest in Talenti through a different entity, Wyndmere. Eventually, David Goliath Group LLC (DGG) became the parent company of Talenti, and Wyndmere became one of several members of DGG. Under state law, Wyndmere (created during the marriage) was presumptively marital property.

The parties married in 1993 and separated in 2013, while DGG's members negotiated a sale to Unilever. The sale closed in December 2014. Per a July 2014 letter of intent, Unilever agreed to pay "an aggregate maximum purchase price" of $350 million-$180 million would be paid at the closing of the transaction. Moreover, members of DGG were entitled proportional shares in two future earnout payments whose value was based on 2015 and 2016 net sales and would not exceed $170 million. The same provisions appear in the parties' purchase agreement. The husband negotiated a separate employment agreement and received extra compensation for the continuing employment.

The district court determined a valuation date of September 2014 and valued the company based on the upfront payment ($180 million). The court found the earnout payments were highly uncertain (they could be as little as "$0," the court said) and represented compensation for the husband's future efforts to grow the company. Therefore, they were not marital property.

A majority of the state Supreme Court disagreed, finding the earnout payments were part of the purchase price. "Wyndmere received the contractual right to the upfront payment and the potential earnout payments only by selling the parties' marital asset, which was acquired during the marriage and before the valuation date." The controlling purchase agreement was unambiguous: all members of DGG had a right to the earnout payments, regardless of whether they continued to work for Talenti, the high court's majority said. " [E]very person with a financial interest in David Goliath shared in the payments." Even if the earnouts' exact value was not certain and the payments were not received before the dissolution of the marriage, "the right to receive the payments was acquired before dissolution, on the date of closing," the court's majority emphasized. A valuation of Wyndmere therefore had to include the earnout payments. The majority remanded, ordering the trial court to value the earnouts and include their amounts in any equitable distribution.

Gill v. Gill, 2018 Minn. LEXIS 613 (Oct. 24, 2018)

Article Exerpted from BV Wire

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