Fall 2019 Newsletter

Firm Values

A Business Appraisal Publication

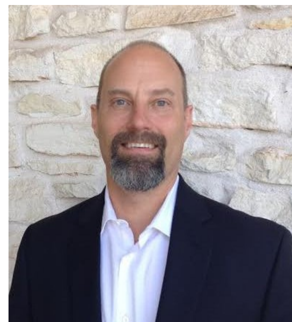
Presented By:

GRW APPRAISAL SERVICES

BUSINESS APPRAISAL AND LITIGATION SUPPORT SERVICES

I provide 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.

Recently, I was elected to the position of president of the American Society of Appraisers - Central Texas Chapter. If you have an agenda you'd like the ASA to consider, please reach out.



Greg Weichbrodt
Principal

This edition of Firm Values presents discussions of the collaborative option for divorce cases, an updated goodwill chart for divorce cases, how company taxation may be treated in the valuation of a pass-through entity, and synergies in business combinations.

The Collaborative Option for Divorce Cases

Collaborative Divorce is process in which each spouse has a specially trained Collaborative Divorce attorney and works through the issues of their case using a method known as "interest-based negotiation". This method enables spouses to formulate agreements that focus on important individual and mutual goals.

Collaborative Divorce is a private and confidential process. Just as in a traditional divorce, each party will have confidential conversations with their attorney and a strategy for accomplishing their goals in the case. In the Collaborative Divorce process it is an intention that those goals are reached without destroying spousal relationships - or exhausting the community estate on a court battle. The process occurs in a private office rather than a courtroom setting. This setting can provide the resources, structure, and emotionally safe space that may be needed for a divorcing couple to consider their unique situation and arrive at a mutually-agreeable, private settlement.

The collaborative process is an alternative to divorce through litigation and we believe most couples would prefer to work through the issues of their divorce outside the courtroom. In the Collaborative Divorce process, clients are required to sign a contract that they promise to try to settle all the issues of their case outside of court and not to threaten to go to court. When that threat is removed, clients may be able to more effectively negotiate the issues in their case. Further, attorneys acting under the Collaborative Divorce model commit to withdrawing from a case if litigation is required. A greater degree of compromise may be required when electing to pursue the collaborative process and at times the parties may not be willing to negotiate without the leverage of litigation. In many cases, though, whether to pursue the collaborative process is worthy of discussion.

Settlements executed through the collaborative process are as binding as the litigated process. Effective September 1, 2011, the application and construction of the collaborative process is codified through Texas Family Code Chapter 15, under the Collaborative Family Law Act.

Collaborative Divorce Texas is an organization formed to support the Collaborative Divorce model and is a good resource to find professionals trained in the process. My firm is a member of Collaborative Divorce Texas and can provide the expertise necessary to assist you or your clients through the financial aspects of Collaborative Divorce.

Updated Goodwill Chart for Divorce Cases

Business Valuation Resources, BVR recently updated its complimentary download "Charting Goodwill Jurisprudence" to give you an at-a-glance look at a state's basic position toward enterprise and professional goodwill. There is an expanded discussion of the law to include excerpts from foundational cases that highlight the concepts (e.g., salability, transferability, solo practice, non-compete agreements) underlying a state's position. The additional information gives insight into how different courts emphasize different concepts and how much discussion there is within a jurisdiction around the basic rule. BVR welcomes input from readers concerning precedent-making new cases or legislative changes in order to keep the chart current.

How Company Taxation May be Treated in the Valuation of a Pass-Through Entity

The Valuation Issue for Non-taxed Entities

A common way to value a company is through the use of the income approach. This approach relies on estimates of future income and the application of an appropriate discount or capitalization rate to determine value. Valuation experts often look to public company data, such as that compiled by Duff & Phelps, for information on the development of discount or capitalization rates.

An issue with electing to utilize public company data is that it is extracted primarily from C-corporations and therefore measures returns that investors have obtained 1) after a deduction for corporate-level taxes and 2) before personal taxes on corporate dividends and capital gains. The tax situation for pass-through entities (e.g., partnerships, limited liability companies, sub-chapter S corporations) is different. Pass-through entities do not pay corporate income taxes. Their owners are taxed on the entities' income that is reported on their personal tax returns, whether that income is distributed or not. As a result, an adjustment to public company discount rate data may be needed before a valuation analyst can apply such data to pass-through entities. The adjustment may be applied directly to the discount rate or to the income stream.

A simple and generally accepted method to treat differing tax situations of C corporations and pass-through entities in the valuation process is to impute a corporate-level tax on the pass-through entities' earnings, and then to apply a discount factor based on public company data. This process is called "tax effecting." Alternatively, several adjustment models have been developed to calculate a value differential between a company taxed at the corporate level and one that is not. This value differential is commonly presented as a percentage premium to the value of a pass-through entity.

Going Forward

The argument for the use of tax-effecting the earnings of pass-through entities for valuation purposes has varied based upon the prevailing tax rate environment. In 1980 and earlier years, there was no reason to assume pass-through entity earnings deserved a valuation premium, and tax-effecting by assuming pass-through income was subject to full corporate tax rates was a straightforward way of avoiding imputing an improper valuation premium. Over the last four decades, there have been periods when it may have been appropriate to assume pass-through income was subject to zero corporate taxes, and also periods when it was appropriate to tax-effect pass-through earnings at some fraction of the full corporate rate.

Currently, value differential calculation models attempt to account for certain tax rules within the Tax Cuts and Jobs Act ("TCJA"). Ultimately, under the rules set by the TCJA, a primary consideration for the use of tax-effecting is dependent upon on the applicability of the 20% Qualified Business Income ("QBI") deduction for pass-through income. When the QBI deduction is not applicable, as in the case of many service companies, the earnings of certain pass-through entities may not warrant a valuation premium, and tax effecting at the full corporate rate may be appropriate. Where the 20% QBI deduction is applicable for the subject company, then partial tax effecting likely is appropriate.

As with any prevailing tax regime, its permanence is not guaranteed. As always, the applied methodology for handling pass-through entities is one in which the appraiser attempts to reflect an investors expected economic reality.

Synergies in Business Combinations

Merger and acquisition (M&A) activity in North America and Europe reached its second highest level on record in 2018. There were 19,501 deals worth $3.6 trillion - a 6.3% increase in deal volume over 2017. There was also a rise in mega deals exceeding $10 billion. Collectively, U.S. corporations had plenty of cash to spend after a long string of solid profits and a significant tax cut. High stock prices also provided plenty of equity for deals involving the exchange of stock, while relatively-low borrowing costs made it possible to finance acquisitions.

Deal and Merger Terms

The primary goal of a merger or an acquisition is to boost earnings growth by expanding operations, gaining market share, or becoming more efficient. Here's a closer look at these important transactions and some possible implications for investors. An acquisition is the purchase of one company by another that is paid for with stock, cash, or both. The target firm is absorbed by the buyer, and the buyer's stock continues to trade. The target firm's shareholders may receive stock in the buying company and/or

have the option to sell their shares at a set price.

A true merger occurs when two companies of roughly equal size combine into one and issue new stock. In this case, stockholders of both companies generally receive shares in the new company. Some transactions that are technically acquisitions are announced as mergers when the deals are friendly, with both sides agreeing to fair terms. When one company purchases a controlling interest in another against the wishes of the target, it's known as a hostile takeover; these transactions are typically announced as acquisitions.

Benefits and Opportunities

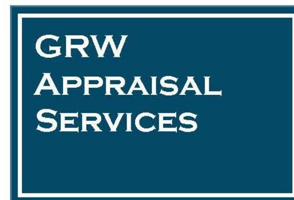
Synergy is the financial benefit that is expected from the joining of two companies. Synergies may be achieved by increasing revenues, gaining access to talent or technology, or by cutting costs. Bigger corporations typically benefit from economies of scale, which may enable them to negotiate lower prices for larger orders with suppliers. In addition, combining two workforces often results in headcount reductions due to redundancies. Companies may combine across industries for strategic reasons such as to eliminate potential competition, or do so to diversify their lines of business. Increased competition from large technology companies has driven merger activity.

In the competitive marketplace, where there are multiple bidders in the acquisition of a target company, a bidder that expects a greater financial benefit from synergies may have an advantage over a bidder who does not. This is so because a bidder that expects synergies likely will place greater value on the target company transaction, all else equal. As a result, such a bidder may elect to share a portion of the expected synergistic value with the target company by paying a greater price. Though in isolation, this perceived value is not inherent in the target company.

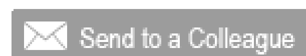
A Soft Plug for GRW Appraisal Services

We provide services including business valuations, divorce expertise, litigation support, forensic accounting, account tracing, and transaction due diligence. For further information about our practice please visit GRWAppraisalServices.com.

We invite you to contact us. Count on GRW Appraisal Services for the experience you need and to provide the personal attention you want. Call or email us today.



GRWAppraisalServices.com * 512.574.3444 * GRWAppraisal@gmail.com



Proud Member