VALUE MANAGEMENT INC.

Investment Banking + Advisory Services

ISSUES + UPDATES SUMMER 2017

Chancery Says Control Premiums Are Real and Legitimate

The Delaware Court of Chancery dismissed a minority shareholder challenge to a going-private merger, concluding the defendant directors did not act in bad faith when they favored the controlling shareholders' bid over a third-party buyer's higher offer.

The dispute arose out of a 2015 merger by which the controlling shareholder of Books-a-Million Inc. (BAM), a retail bookseller, bought the outstanding shares it did not already own in the company for $3.25 per share. A third party had offered to buy 100% of the company's shares for $4.21 per share.

The transaction satisfied the requirements the Delaware Supreme Court had outlined in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014). Specifically, the board had set up a special committee that needed to give its approval to the transaction. The special committee retained independent legal and financial advisors for the transaction. Moreover, a majority of the minority shareholders approved the merger.

Two plaintiffs challenged the transaction with the Delaware Court of Chancery, alleging members of the board and special committee had breached their fiduciary duties to the shareholders. They did so because no rational director would reject the third-party bidder's "substantially superior offer," which was nearly 30% higher than the controlling shareholder's offer, the plaintiffs said.

The Chancery noted the two offers were fundamentally different. The reality is that buyers of corporate control have to pay a premium above the market price, the court said. What's more, "the law has acknowledged, albeit in a guarded and complex way, the legitimacy of the acceptance by controlling shareholders of a control premium." Here the third party's bid incorporated a premium to buy corporate control, whereas the controller's bid contemplated a discount for the minority shares.

According to the Chancery, the discount here was not so extreme as to suggest any of the defendants

(continued on page 2)

In This Issue:

VMI Highlights:

Greg Kniesel spoke at the ESOP Association's Annual Conference in Washington, DC. His topic was "Fiduciary Responsibility for Value Determination."

Andrew Wilusz spoke to the Bucks County Estate Planning Council on Ethics for the Estate Planner in early 2017.

Andrew Wilusz will present "Sailing the Seven Cs of Ethics for Corporate and Tax Attorneys" at Flaster Greenberg on July 11th. The Lunch & Learn ("L&L") will earn one Ethics CLE hour. Andrew will also present at Klatzkin & Company on July 13th. This 2-hour, 3-part L&L covers: Part 1 "A Primer on What You Look At and What You Look For in Business Valuations"; Part 2 "Readying a Business to Maximize Sale Price" and Part 3 "An Overview of Due Diligence Issues in the Sale or Purchase of a Business." **Please contact Susan Wilusz at smw@valuemanagementinc.com if you are interested in having Value Management host a "Lunch & Learn" at your firm!**

(Continued from page 1)

tried to enable a sweetheart deal for the controlling shareholder.

The court said the business judgment rule applied, which prescribed the lowest level of scrutiny of the deal.

Considering a special committee met more than 30 times to negotiate the merger, pursued third-party bids to test the controller's offer, and achieved a 20% increase in the sales price over the initial offer, the only rational conclusion was to consider the transaction fair to the minority shareholders, the Chancery said. It granted the defendants' motion to dismiss the complaint.

The case is in reference to Books a Million Stockholders Litig., 2016 Del. Ch. LEXIS 154 (Oct. 10, 2016).

Valuation Issues KO'd a Third of M&A Deals in 2016

Disagreement over valuation is the most prevalent reason a merger or acquisition fails to be completed, according to a report from KPMG. In a survey, over a third (36%) of respondents say valuation issues were the primary reason for deal failures over the past 18 months. The other reasons are: loss to a competing bid (22%), financial issues revealed during due diligence (11%), operating issues revealed during due diligence (11%), management issues or lack of fit (9%), recent regulatory changes (4%), changing industry-specific conditions (4%), and changing macroeconomic conditions (3%).

Global Brand Acquisition Values Up

After a long-term downward trend, brands seem to be back in the focus of M&A investors, according to a new report. The year 2015 could mark a turning point," says the report, MARKABLES Global Top20 Brands. Some highlights of 2015:

- The top two most expensive brand acquisitions of all times were transacted: **Kraft Foods** (by Heinz) and **Newport** (by Reynolds American);
- The average value of the Top20 brands increased to $5.6 billion, up from $2.1 billion in 2014;
- Top20 brands account for 41% of the value of the enterprises to which they belong, up from 34% last year; and
- The year 2016 was expected to be an even better year for brands in M&A, with some landmark acquisitions (SABMiller, Time Warner, Linkedin, Monsanto, Chubb, Starwood Hotels, and other).

The report's data come from public-company financial statements, and the amounts reflect what an acquirer or investor is willing to pay for a brand. Real transactions of brands give a unique insight into the understanding of what drives value.

Most Family Businesses Need a Good Succession Plan

Only 23% of family businesses have a robust succession plan in place, according to a new report from PricewaterhouseCoopers. Also, only 46% of the family businesses polled said they are reluctant to pass the business on to the next generation. To discuss business succession planning and/or liquidity options, contact Andrew Wilusz at 215.343.0500 or amw@valuemanagementinc.com.

Coffee: It's All About the Brand

Coffee is a perfect example of how branding can add value to a business. Despite being a commodity with little room for differentiation in a mature market, branded coffee businesses show strong profitability and enterprise value. This is due to branding and the resulting consumer preferences it triggers. In blind testing, consumers taste differences between bean or roast varieties, but such differences are virtually nonexistent between brands. In such cases, it is the brand that makes the difference, not the product itself.

Good to the last drop: In an analysis of 18 global coffee brands acquired between 2004 and 2015, average royalty rates for coffee trademarks were between 3.5% and 4%, according to data from MARKABLES. The trademarks of coffee businesses account for 20% of enterprise value, ranging from 10% to 30%. The average sales multiple paid for coffee businesses is between 1.5x and 1.75x revenues. The peer group includes brands like Folgers, Van Houtte, Douwe Egberts, Café Bustelo,

Café Pinon, among others. Not bad for a product that is basically a commodity, and for peers that are mostly second- or third-tier players. Valuation multiples for the market's leading brands would be even higher, but they are rarely subject to acquisition.

Rogue One Film Points Up Celeb Estate Valuation Issue

The value of the estates of famous actors could get a boost thanks to last year's "boffo pic" *Rogue One*. In the film, the late actor Peter Cushing was "digitally resurrected" and appears as the future Death Star commander. Some stars are now taking action, such as having themselves scanned, so they, too, can provide for their heirs when they're in the hereafter, according to an article in *Variety*.

Real force: There can be a great deal of value in a celebrity's posthumous right of publicity—a form of intellectual property that covers an individual's likeness, name, signature, voice, and so on. True, celebrities have been re-created before in various commercial projects, but the technology has broken new ground with the latest film. Of course, there's speculation that we will continue to see Carrie Fisher as Princess Leia in future *Star Wars* installments.

Determining the fair market value of a posthumous right of publicity can be difficult, and there can be wide swings in opinions of value. The estate of Michael Jackson valued his name and likeness at $2,105, but the IRS says the value is a whopping $434 million—quite a gap. This dispute is set to be resolved sometime this year. Also, whether a person's right of publicity continues after death is a matter of state law—not all states recognize it.

Busy Time for Law Firm M&As

It was another busy year in 2016 for law firm M&As, according to a release from Altman Weil, which tracks this activity. Eighty-five law firm combinations were announced in the U.S. in 2016, maintaining its pace since 2013, when U.S. law firm M&A activity dramatically accelerated coming out of the recession. Most combinations last year did not involve large firms—84% were acquisitions of small law firms with 20 lawyers or fewer.

Note Well: There are certain nuances involved in valuing a law firm. For example, one special consideration that demands investigation is the "origination credit" aspect of compensation plans. Origination credits are given to staff for bringing a client into the firm. There may be a formula that gives the originator a percentage of billed fees right off the top. This system works great for some firms, but other firms have trouble trying to figure out who originated what. It is important to learn whether origination credits are used, what formula is used, and how the plan is working out.

Healthcare Multiples

The S&P Healthcare Services Index increased 5.3% over the last month, outperforming the S&P 500, which increased 1.8% over the same period, according to the *January 2017 Healthcare Sector Update* from Duff & Phelps. The best performing sectors were assisted/independent living (up 17.5%), HCIT (up 10.8%), and emergency services (up 10.6%). The poorest performing sectors were skilled nursing (down 6.3%), diagnostic imaging (down 4.3%), and dialysis services (down 3.4%).

The current median LTM revenue and LTM EBITDA multiples for the healthcare services industry overall are 2.34x and 13.2x, respectively. The sectors with the highest valuation multiples include: consumer-directed health and wellness (3.92x LTM revenue, 25.0x LTM EBITDA); HCIT (5.27x LTM revenue, 22.9x LTM EBITDA); other services (2.07x LTM revenue, 19.6x LTM EBITDA); and care management/TPA (1.08x LTM revenue, 19.5x LTM EBITDA).

Chancery Bases Fair Value Calculation on Income-Based Model

In a statutory appraisal action, the Delaware Court of Chancery rejected the deal price as evidence of fair value, citing a suboptimal sales process. Only an income-based approach that the experts for both parties used represented a reliable methodology, the court found. The court provides a useful discussion of synergy and critique of the experts' input choices.

The dispute arose out of the 2014 merger of two small community banks that the same family, the Snyders, controlled. The banks, Farmers & Merchants

Bancorp of Western Pennsylvania (F&M) and NexTier, underwent a stock-for-stock transaction based on an exchange rate that implied a valuation of $83 per share for F&M and a valuation of $180 per share valuation for NexTier.

At trial, the minority shareholders (petitioners) and the bank (respondent) offered expert testimony from experienced valuators.

The bank also claimed the merger price was "a strong indication of the value of F&M." The court disagreed. Typically, it is appropriate to rely on the deal price if there was a "robust" sales process, the court observed. This was not the case here. F&M pursued the merger at the request of the controller, which "stood on both sides of the transaction." There was no auction—no one reached out to potential third-party buyers. And, even though F&M's board installed a special committee, "the record does not inspire confidence" that an arm's-length transaction took place. The court gave no weight to the merger price.

The expert valuations had flaws as well, the court found. It ultimately performed its own income-based analysis by drawing on the experts' opinions.

The petitioners' expert based his value conclusion — $137.97 per share (i.e., 66% above the deal price!) — on a comparable transactions analysis. He performed a discounted future benefits analysis as a cross-check; this calculation produced a value of $139.45 per share, taking into account certain adjustments.

The comparable analysis was unacceptable, the court found, because it failed to account for any synergistic value captured in the eight comparable transactions. "Fair value," in the context of statutory appraisal, means "the value to a stockholder of the firm as a going concern, as opposed to the firm's value in the context of an acquisition or other transaction." Instead, the petitioners' expert assumed "bankers who buy other banks don't pay for synergies." The court observed that public statements related to the comparable transactions (press releases, proxy statements, database reports) expressly mentioned potential synergies.

The respondent's expert based his value conclusion — $76.45 per share—on three methods whose results he weighted equally. The court rejected his M&A analysis because "too much doubt exists over the appropriateness of the comparables." It also found his guideline public-company valuation was problematic because the selected companies had low trading volumes.

All told, the court adopted all of the respondent expert's inputs, except for beta, and arrived at a fair value of $91.90 per share for F&M.

The case is Dunmire v. Farmers & Merchants Bancorp of W. Pa., 2016 Del. Ch. LEXIS 167 (Nov. 10, 2016).

Healthcare M&A Volume Up, Spending Down in 2016

The healthcare merger and acquisition market was up slightly in 2016 in terms of deal volume, but overall spending was down 36% from 2015, according to data from Irving Levin Associates Inc. There were 1,536 transactions in 2016, up 1% from 2015, but overall spending dropped to $255.7 billion from $400.3 billion in 2015. Healthcare sectors showing the biggest jumps in deal volume include eHealth (up 23%), rehabilitation (up 21%), and physician medical groups (up 19%). The biggest declines were in managed care (down 53%), labs/MRI/dialysis (down 21%), and hospitals (down 12%).

The strong M&A market for physician groups is likely to continue due to the uncertainty surrounding the potential repeal and replacement of the Affordable Care Act. These groups have partnered with hospitals because they see a difficult time ahead, especially if they have not developed a specialty niche.

Global BV News: China Cracks Down on Trademark Infringement

Courts in China are taking trademark infringement more seriously. Two Chinese firms and the founder of one of them have been ordered to pay BMW over $400,000 for registering trademarks similar to that of the German automaker, according to the *Shanghai Daily.* This action comes on the heels of a case involving basketball star Michael Jordan, who won a long-running trademark case relating to a local sportswear firm using the Chinese version of his name. China's highest court ruled in his favor, overturning earlier rulings against the athlete.

Ripple Effect of New, Simpler Goodwill Impairment Rule

Public and private companies alike will soon be using a streamlined process for testing for goodwill impairment. The Financial Accounting Standards Board (FASB) released Accounting Standards Update 2017-04, *Intangibles—Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment* (ASU 2017-04). The ASU establishes a one-step process for testing goodwill for a drop in value.

The new rules call for a goodwill impairment loss to be measured as the excess of the reporting unit's carrying amount over its fair value. It eliminates Step 2 that requires the impairment to be measured as the difference between the implied value of a reporting unit's goodwill with the goodwill's carrying amount.

Impact: In 2014, the FASB allowed private companies to use a simplified impairment model, and that move triggered the current action for public companies. Although the goodwill alternative was designed to cut the cost of compliance for private firms, it was believed that some would not elect to adopt it. That's because, if they were acquired by a public company, they would have to undo the election and restate financial statements. Now that public companies will use the same model, the restatement issue disappears, clearing the way for private-company adoption.

The revised guidance will be applied prospectively and is effective for calendar year-end SEC filers in 2020. Other public-business entities will have an additional year. All other entities that have not elected the private-company goodwill alternative are required to adopt in 2022. Special transition guidance is provided for private companies that have elected the private-company goodwill alternative. Early adoption is permitted for any impairment tests performed after Jan. 1, 2017.

Tech IPOs Have Lost Value

A third of tech companies that have had IPOs in the last decade are now trading beneath their initial valuation, according to analytics firm Geckoboard. The underperforming companies include Twitter, which was worth $24 billion at the end of its first day on the stock market and is now worth half that as it keeps looking for a buyer. Other "notorious flame-outs" include mobile game company Zynga, which has lost 66% off its IPO value after floating at $6.6 billion in 2011.

Shareholder Approval 'Cleanses' Potential Undervaluation

Shareholders protesting what they considered a rushed sale at a bargain basement price suffered defeat in the Delaware Court of Chancery when the court ruled strong shareholder approval of the proposed merger had taken care of any problematic conduct on the part of board members overseeing the transaction.

The target of the cash-out merger was a global chemical and technology company that was comprised of several distinct business groups. Before the transaction, it confronted two major problems. One was a failed acquisition strategy that cost the company $1.5 billion and produced dismal results. The other was a vocal activist investor that criticized the strategy the company was pursuing in a public letter and in a presentation to the Securities and Exchange Commission.

For years, strategic buyers made known their interest in buying segments of the company's business. In the fall of 2014, the company retained BNP Paribas (Paribas) to explore value creation strategies. Paribas, at one point, noted the difficulties of maximizing value through a sale because few strategic buyers were interested in acquiring the whole company, considering the company's diversity of assets limited the number of merger candidates. But a transaction with a financial buyer would limit the premium a sale could achieve given a lack of operational synergies.

Two bidders, Apollo and Platform, submitted a joint bid to acquire the entire company. The company's board authorized management to pursue the bid and also asked Paribas to reach out to other potential buyers provided the bidders were financial buyers that would acquire the entire company. This directive seemed to conflict with the Paribas' suggestion that a deal with a financial sponsor would not produce maximum value.

The board also hired Deutsche Bank (DB) to serve as a second financial advisor. In a January 2015 presentation, DB stated no strategic bidder wanted to buy the entire company. It also said the implied per-share price for the entire company was $36.80. In April 2015, Apollo/Platform offered to buy the company for $34 per share. A few days later, DB presented the board with a DCF analysis that valued the stock at $35.27 per share.

Around that time, the company also negotiated a settlement with the activist investor, without ever revealing that the company was actively selling itself.

The board approved the Apollo/Platform bid and both financial advisors submitted opinions that the transaction was fair to the shareholders. During the go-shop period, only one serious contender emerged that offered to acquire the company for between $35 and $36 per share. However, it was a foreign company and faced a legal obstacle to acquiring the subject. When it asked the board to postpone the stockholder vote on the Apollo merger to have time to resolve its legal problem, the board declined.

The Apollo/Platform deal closed at the end of October 2015. Most of the shares that voted at the stockholder meeting approved the merger. But a number of dissenting shareholders filed suit with the Delaware Court of Chancery. The defendants—mostly board members—filed a motion to dismiss the complaint.

The gist of the complaint was that the defendants breached their fiduciary duties. Specifically, the board sought to avoid an embarrassing public proxy fight and rushed to sell the company as one entity even though one of the financial advisors to the transaction had suggested that selling segments of the company to strategic investors would produce maximum value.

The Chancery said the paramount issue was by which standard of review the court should assess the directors' decision-making. Since the disinterested stockholders in this case overwhelmingly approved the transaction, the business judgment rule, the most relaxed level of scrutiny, applied, the court decided. This meant the court would not second-guess the conduct of the board unless the transaction presented waste, which the plaintiffs did not allege.

The plaintiffs' effort to get around the fact that there was robust stockholder approval by arguing the vote was not fully informed because the defendants failed to disclose material information did not resonate with the court. Overwhelming stockholder approval "cleansed any failure of the OM Board to act reasonably to seek the transaction offering the best value reasonably available," the court said. It dismissed the case.

The case is in reference to OM Group, Inc. Stockholders Litig., 2016 Del. Ch. LEXIS 155 (Oct. 12, 2016).

VALUE MANAGEMENT INC.
Investment Banking + Advisory Services
2370 York Road, E2 | Jamison, PA 18929

Address Service Requested

PRSRT FIRST CLASS
U.S. POSTAGE
PAID
HAVERTOWN, PA
PERMIT NO. 45