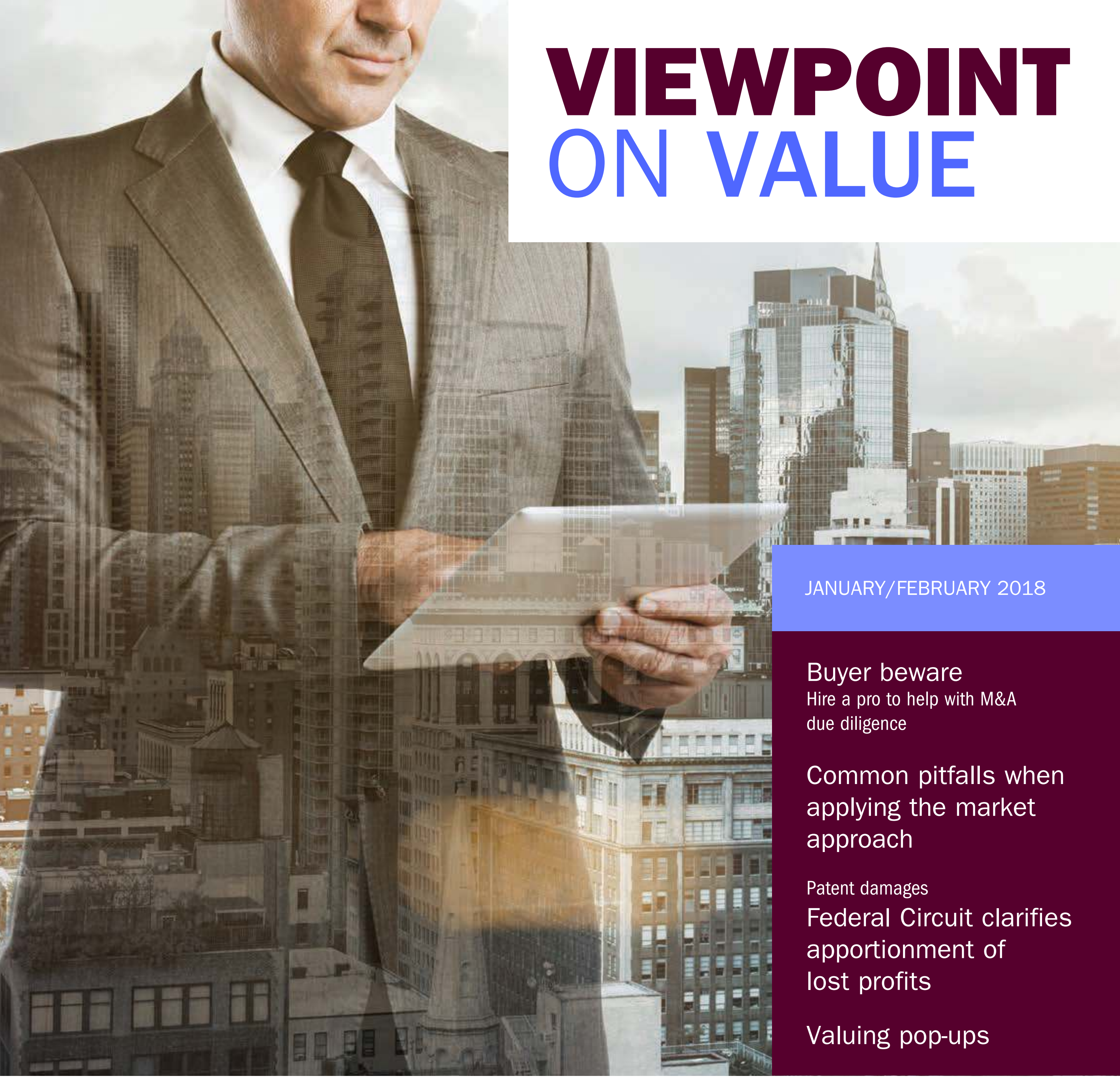

VIEWPOINT ON VALUE

JANUARY/FEBRUARY 2018

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Common pitfalls when applying the market approach

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Federal Circuit clarifies apportionment of lost profits

Valuing pop-ups

Do you have a **Question?** or want to speak to
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Buyer beware

Hire a pro to help with M&A due diligence

The merger and acquisition (M&A) market is currently hot in many industries. But, before merging with another business, it's important to do your homework. In addition to evaluating historical and prospective financial statements, a valuation professional can help buyers identify potential hidden liabilities and misrepresentations.

Buy-side due diligence

A buyer's offer is based on how much return the business interest is expected to generate. Fair market value is a good starting point, but buyers may be willing to pay more (or less) depending on the situation.

For example, when a distressed seller is desperate for cash, a buyer may be able to purchase the company at a *discount* from fair market value. Conversely, if the M&A market in a particular industry is hot and the purchase enables a buyer to achieve acquisition synergies, the business may be sold for a *premium* above fair market value. When figuring out how much to offer, buyers need to review copies of historical and prospective financial statements.

In terms of the acquisition target's historical performance, evaluate a full business cycle, including any cyclical peaks and troughs. If a seller provides statements during only peak years, there's a risk that the buyer could overpay.

On the other hand, *prospective* financial statements are based on management's expectations for the future. When reviewing these reports, evaluate the underlying assumptions and play devil's advocate. After all, prospective financials are often the primary basis for the buyer's offer price.

For instance, suppose management expects to grow at 15% annually. The buyer needs to recognize that fixed assets and human capital have limited capacity, so fixed costs probably can't sustain such high growth over the long run. At some point, the business will need to buy more equipment, open additional facilities and hire more managers to achieve forecasted revenue. So, carefully review the terminal (or residual) value that's included in any discounted cash flow analysis.

Also, ask who prepared the prospective financials. If they're prepared by an outside accountant, do the reports follow the standards provided by the American Institute of Certified Public Accountants (AICPA)? Buyers may have more confidence in projections and forecasts prepared by outsiders — especially if they conform to AICPA standards — but these reports are typically based on *management's* assumptions. Because management may have a financial incentive to paint a rosy picture of financial performance, it's a good idea to hire your own expert to perform an independent analysis.

Recent developments that affect gift and estate tax valuations

In August 2016, the IRS proposed changes to the tax code intended to curb abusive estate planning practices involving family limited partnerships (FLPs) and other family-controlled entities. Specifically, the proposal called for changes to the treatment of certain lapsing rights and restrictions on liquidations in determining the value of transferred interests in family-controlled entities under IRC Section 2704.

Business owners, valuation professionals and the American Institute of Certified Public Accountants (AICPA) criticized the proposal for being too broad and general. They were concerned that the proposal appeared to 1) extend to operating businesses, and 2) eliminate valuation discounts for lack of control or marketability for family-controlled entities. Last fall, the U.S. Treasury Department and IRS officially withdrew this proposal in its entirety.

So, FLPs remain a viable estate planning tool for the time being. But, as of this writing, Congress is also considering a tax reform framework that would eliminate estate and generation-skipping transfer taxes altogether.

Check with your valuation advisor for the latest information. This framework is preliminary and basic. It's possible that more detailed tax reform legislation may be enacted by the time you're reading this.

Beyond the financials

Historical balance sheets tell buyers about a company's tangible assets, acquired intangibles and debts. But some liabilities may not appear on the financial statements. Examples of unrecorded liabilities include:

- Pending lawsuits and regulatory audits,
- Warranty and insurance claims,
- Uncollectible accounts receivable, and
- Underfunded pensions.

Hidden liabilities can be a major issue in stock sales. Unlike asset sales, in which the buyer cherry-picks assets and liabilities to acquire, stock sales transfer all the outstanding shares of stock to the buyer, and the business continues to operate uninterrupted. From a legal perspective, that means the buyer may be vulnerable to future lawsuits, such as employee discrimination or intellectual property claims that relate to conditions that existed before the deal closed.

Some issues, like broken equipment or obsolete inventory, can be unearthed only with a physical observation, so it's important for buyers to tour the company's facilities with any outside experts that are hired to help conduct due diligence.

Buyers also need to be skeptical of representations the seller makes to seal a deal. Misrepresentations that are found after closing can lead to expensive legal battles. An earnout provision or escrow account can be used to reduce the buyer's risk that the deal won't pan out as the seller claimed it would.

Hire a business valuation expert

Mistakes can be costly in M&A. Many private business owners are inexperienced when it comes to these complex deals. So, it usually pays in the long run to hire an outside business valuation expert to help evaluate the deal. ■

Common pitfalls when applying the market approach

The market approach is based on a straightforward premise: The value of a business can be derived from the prices others are paying for similar businesses. But, in practice, this valuation technique isn't nearly so simple. There are a number of pitfalls experienced experts have learned to avoid.

Failure to recognize public vs. private company differences

Under the market approach, comparables (or guideline companies) can be publicly traded or privately held. Although the data for public transactions is usually readily available, the size of public companies and the motivations of their buyers and sellers can make these transactions less relevant when the subject is a small or midsize private company.

In addition, pure players (companies that focus on a single target market or offer a limited menu of products) can be hard to come by in the public markets — especially in industries dominated by conglomerates.

In general, the guideline public company method makes more sense if the subject company is large enough to consider going public and when valuing a minority interest in a going-concern business. Moreover, using public stock prices to value a controlling interest may require subjective adjustments for control.

Insufficient selection criteria

There are various proprietary databases that valuation experts can search for comparable transactions involving private businesses. But, just because two companies operate in the same industry, that alone doesn't guarantee they're similar. Other factors experts may consider when using the market approach include:

Size. Large entities tend to have professional management, more sophisticated financial reporting and controls, and more cash reserves to help them weather downturns. It's also important to consider the relevant size of the company's market.

Geographic location. A business's location may affect competitive forces, such as regulatory requirements and the number of competitors and suppliers.

Financial performance. Examples of possible financial performance criteria include debt ratios, profit margins and working capital.

In addition, the transaction date is increasingly relevant in today's volatile marketplace. Old transactions may not be relevant if market conditions have changed. For instance, is a low point in the industry's cycle driving values down (or vice versa)?

Failure to look beyond selling price

After an expert has identified relevant transaction data, he or she must delve into the details to understand the transactions' terms and the elements driving their value. In some cases, the selling price listed in a transaction database may not tell the full story.

For example, part of the purchase price might be buried in employment contracts or be contingent on future operations. The use of these alternative terms can make a deal more (or less) valuable than it appears on the surface, necessitating adjustments to arrive at a cash-equivalent value.

Failure to understand comparable data

Another common mistake that may occur under the market approach is failing to adjust the financial statements of the subject company or the comparables companies to ensure accurate comparisons. For example, nonrecurring items and discontinued operations may need to be eliminated.

Or, for comparative purposes, a valuation professional may need to rectify differences in accounting methods — say, for reporting depreciation or inventory. Ideally, an expert makes these adjustments before selecting guideline companies and computing pricing multiples.

Inconsistent terminology may also lead to problems. Slight differences in the ways databases or experts define terms such as "cash flow" or "earnings" can trigger significant valuation differences. It's imperative to understand how each database defines variables as well as what's included or excluded in the selling price.

It's also important to consider timing. For instance, is a low point in the industry's cycle driving values down (or vice versa)?

Use with caution

Many judges and attorneys prefer the market approach over the income approach for its perceived objectivity. But applying the market approach isn't as easy as it appears on the surface. It's important to hire an *experienced* business valuation expert to avoid potential pitfalls and arrive at a value that can withstand scrutiny. ■

Patent damages

Federal Circuit clarifies apportionment of lost profits

In *Mentor Graphics Corporation v. EVE-USA, Inc., et al.*, the U.S. Court of Appeals for the Federal Circuit provided welcome guidance on apportionment of lost profits in patent infringement cases. The court held that, when a plaintiff establishes its entitlement to lost profits under the *Panduit* test, the award reflects damages attributable to the product's patented features. So, no further apportionment is required.

A simple case

For patent litigation, the facts of *Mentor* were remarkably simple. The relevant market — suppliers of emulators to Intel — consisted of just two parties: the plaintiff (Mentor Graphics) and the defendant (collectively referred to as Synopsys, the parent company of EVE-USA, Inc.). At trial, the issue was whether Synopsis' emulators infringed Mentor's patent related to debugging source code in simulation/emulation technology. The jury ruled in favor of the plaintiff, awarding it more than $36 million in lost profits.

On appeal, the defendant challenged the infringement finding and argued that damages

should be apportioned to reflect only those profits attributable to the patented features. The Federal Circuit found substantial evidence to support the jury's verdict and affirmed the damages award, rejecting the defendant's apportionment argument.

Panduit test

A landmark patent infringement case, *Panduit Corp. v. Stahlin Bros.*, created a widely accepted framework for determining patent damages. Under the *Panduit* test, a patent holder is entitled to lost profits if it can establish:

1. Demand for the patented product,
2. Absence of acceptable noninfringing substitutes,
3. Manufacturing and marketing capacity to exploit the demand, and
4. The amount of profit it would have earned but for the infringement.

The defendant didn't challenge the jury's finding that the plaintiff satisfied all four *Panduit* factors, nor did it dispute the amount the plaintiff would have earned but for the infringement. Rather, the defendant advocated a two-step approach to calculating lost profits: 1) Calculate total lost profits under *Panduit*, and 2) apportion lost profits to include only those attributable to the patent holder's "inventive contribution."

The defendant argued that the emulators consisted of thousands of software and hardware features. But only two of those features allegedly infringed the plaintiff's patent.

Apportionment included

The Federal Circuit acknowledged the importance of apportionment but held that it was already incorporated in the plaintiff's lost profits analysis. According to the court, the *Panduit* test's requirement that a plaintiff prove 1) demand for its product and 2) the absence of noninfringing alternatives "ensures that damages are commensurate with the value of the patented features."

The court found that Intel wouldn't have purchased emulators without the patented features — a finding the defendant didn't dispute on appeal. Absent noninfringing alternatives, the plaintiff was the only company that could sell Intel an emulator with all the required features.

The court rejected the defendant's argument that, without apportionment, multiple patent holders could recover lost profits on the same product. Under *Panduit*, the court explained, a patent holder can't obtain lost profits unless "it and only it could have made the sale." When a product contains multiple features patented by separate companies, no single company would have the right to sell them all, so none could obtain lost profits. Rather, they would be entitled to reasonable royalties for their respective contributions.

Making the plaintiff whole again

Ultimately, the court's analysis came down to whether the damages award was adequate to place the plaintiff in the position it would have occupied had there been no infringement. Simply put, had the infringer not infringed, how much money would Mentor have made? In this case, the answer was approximately $36 million. ■

Valuing pop-ups

Pop-up stores and events are sweeping the retail, restaurant and entertainment industries — and many are remarkably profitable. Here are some key cost considerations and risks to consider when evaluating a pop-up's business model.

What's a pop-up?

Retailers have been using pop-ups for decades primarily to peddle seasonal goods, such as Halloween merchandise or ice cream treats in the summer. But during the recession, many entrepreneurs turned to these temporary, low-rent outlets as a responsible, cost-effective way to grow their operations.

Today's pop-up stores often supplement the online distribution channel. That is, they might carry small amounts of inventory, but also allow customers to purchase items from the company's website. Turns out, many shoppers still want to touch, taste or try on merchandise before buying it. Pop-up stores also tend to forgo traditional print and radio ads, turning instead to word-of-mouth and social media marketing.

Some pop-ups are standalone; others operate in the front of traditional brick-and-mortar stores. Examples include:

- A food truck stand located in a bar's parking lot that changes vendors daily,
- A mock dorm room inside a university student center that's open in August to sell bedding and backpacks,
- A pop-up nightclub that operates on Thursday and Friday nights from a vacant warehouse, and
- A software kiosk in a busy office complex that allows workers to try out new products.

Some businesses, including start-ups, use pop-ups to test new products and locations before committing to a major launch. These outlets allow business owners and customers to interact directly, providing immediate feedback and enhancing the customer experience.

How do pop-ups differ from brick-and-mortar locations?

The most obvious advantage to operating a pop-up is lower costs. In addition to paying less in rent, pop-ups incur lower advertising costs and carry less physical inventory. In addition, owners of pop-ups are generally more in tune with customer needs and can adapt quickly to changes in demand.

But pop-ups can have major drawbacks, too. For example, landlords may evict a pop-up if a longer-term tenant signs a lease for the space. Seasonal pop-ups have a limited capacity to generate cash flow each year. And trendy pop-ups face the possibility that their novelty may wear off.

Pop-ups also face capacity issues. That is, they're small and can serve a finite number of customers. To reach projected growth, an entrepreneur may need to open additional pop-up locations.

Here today, gone tomorrow

It's important to recognize these differences when projecting a pop-up's future cash flow or choosing guideline comparables to apply under the market approach. Valuing pop-ups requires discretion and a keen understanding of their unique opportunities and risks. ■

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Michael has more than 30 years of experience with a focus on valuation, litigation support, and taxation issues. He has additional expertise in auditing, financial statement analysis and consulting. His traditional accounting experience, includes taxation and financial statement reporting for closely held businesses, with a concentration on professional practitioners, real estate developers, construction contractors, retailers, manufacturers, and computer hardware and software providers.

Michael earned his Bachelor of Science Degree from the University of Delaware. He holds accounting certifications in both New Jersey and New York. Michael is a member of the American Institute of Certified Public Accountants (AICPA), a recipient of the AICPA's Accredited in Business Valuation (ABV), and Certified in Financial Forensics (CFF) designations. Michael is a member of the New Jersey Society of Certified Public Accountants (NJSCPA), where he was the Group Leader of the Business Valuation, Forensic & Litigation Services Interest Group, and is currently on the Steering Work Group. He is certified by the National Association of Certified Valuation Analysts (NACVA), and holds that organization's highest designation as a Certified Valuation Analyst (CVA). He is accredited as a Certified Fraud Examiner (CFE). In addition, Michael is an Accredited Senior Appraiser of the American Society of Appraisers (ASA).

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