

Business Valuation Notes

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Holy Grail...

PROPRIETARY SELLERS

But Watch for the Reason for Selling ...

Minneapolis based entrepreneur Jim Thomas recently called "Proprietary Sellers" the "Holy Grail" of business acquisition and advised those searching to buy a company to "work hard" and "investigate many deals" to find such sellers. An important element in such prospecting is learning the 'personal issues' of the seller early in the due diligence process, Thomas said, to be assured that there really is a willing seller.

Proprietary sellers are those business owners who represent themselves and their companies instead of engaging an intermediary, such as a broker, to seek a buyer.

The comments from Thomas were in a follow up article by him stemming from a May 2007 M&A Magazine article by him. His remarks arose from comments by business brokers, intermediaries, and independent sponsors who contacted him following that article and who wanted to learn more about how to succeed with proprietary sellers. Thomas is founder of Dynamic Capital Partners, an entity solely owned and operated by him (<http://www.dynamicdevelopmentalcapital.com>) for the purpose of evaluating and purchasing a company. Thomas partners with Kerry Baubie, a seasoned CFO, to jointly evaluate possible acquisitions. Thomas also has created a local Fun-d-less Sponsors Group of prospective independent buyers of businesses.

Group President Randall Schostag considers it important that prospective sellers and merger and acquisition service providers understand individuals like Thomas and similar prospective buyers. "While peripheral, I think they are key players and influential in the market for buying and selling companies," Schostag said. "Too often we in corporate finance get bogged down with the 'numbers'. Thomas reminds us to think carefully and early about the human side of a business sale.

"These potential buyers are sophisticated in that they have 'real world' experience operating businesses successfully and are usually also in contact with persons who also represent deal makers who represent funds which invest money for institutions and other large investors. Therefore, they tend to be very knowledgeable and also provide introductions to other potential buyers after they 'pass' on a deal."

Thomas is a successful executive who has built and sold two privately held businesses. He is active in several business organizations and also formed the Fun-d-Less Sponsors, a group of other local private investors who meet monthly to discuss deals which they are looking at and offer leads for businesses which may be of interest to others in the group. MBVG was a guest speaker at the August

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POTENTIAL PENALTY DON'T RELY ON INCOMPETENT APPRAISER

A United States Court of Appeals has remanded to the Tax Court a case to determine if the taxpayer's reliance on an unqualified appraiser should be considered 'reasonable' and made in 'good faith' or not in good faith and therefore subject to an 'accuracy-related' penalty.

The case was decided August 23, 2007, by the U.S. Court of Appeals for the Second Circuit in the matter of Estate of Josephine T. Thompson, et. al. versus the Commissioner of Internal Revenue.

MBVG Vice President Steve Saracco, noted the importance of using certified and qualified appraisers and said that was a key reason that Olsen Thielen had purchased MBVG.

In the preceding tax court decision made July 26, 2004 (Tax Court Memo (RIA) 2004-174) the court was presented with a valuation by the estate of \$1.75 million while the IRS provided a valuation of \$32 million. The tax court rejected both valuations: "...the Estate employed a method that exaggerated the risks associated with technological change, while the Commissioner's methodology was generally deficient." The tax court, therefore, using its own methods determined the value to be \$13.5 million.

On appeal, the estate argued the tax court should be compelled to adopt the estate's valuation once it rejected the commissioner's. The IRS appealed stating that the estate's underpayment

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INCOMPETENT

was so large that it was an error for the tax court to not impose an underpayment penalty.

The company subject to the valuation was Thomas Publishing Co., Inc., an old, established closely held firm which produces business-to-business industrial and manufacturing directories and publications. The business was solely paper-based until the 1990s when it began to use digital technology. It offered its directories on CD-ROM in 1993 and made its directories available on the Internet in 1995. By 1998, the Company's website was recognized as the sixth-ranked business-to-business website in the United States. From 1995 to 1998 print subscriptions fell while CD-ROM and Internet subscriptions rose significantly.



Schostag

In the six years preceding Thompson's death, Thomas Publishing's net sales grew 53%, but with expenses growing at the same pace, operating income remained comparatively constant around \$25 million. In the three years following Thompson's death, net sales averaged about \$273 million, but dropped to \$235 million in 2002 while operating income dropped, turned to losses, and the Company ended 2002 barely breaking even.

In valuing the company, the estate apparently primarily relied on the income approach, specifically the capitalization method. After valuing the firm, the estate then added in the value of the non-operating assets. The capitalization rate consisted of the build up method, common to the valuation community, arriving at a 30.5% cap rate. The rate was large because the unique risk added was 12% for Internet and management risk. Using a very high rate, such as the estate did, produced a low value for the common stock. The analyst then reduced the value further by assuming that the value obtained was that of a controlling interest and thus reduced the value by 40% for a discount for lack of

control and by another 45% for a discount for lack of marketability.

MBVG President Randall Schostag said that a capitalization rate of 30.5% would be considered very high by most standards and that he would not expect a rate that high, especially after allowing for a growth rate adjustment, in any but the riskiest of firms. The transition from a paper-based firm to one using CDs and Internet for delivery mechanisms does not at first glance seem to warrant such a high rate.

Schostag said that he is unable to ascertain how the discount for lack of marketability should be treated, as there was too little information in the court decision. However, he thought that, again at first glance and without knowledge of the company and how it was managed, that a discount for lack of control of 40% seemed steep.

Looking at the Commissioner's methods, the IRS used two independent methods: the public guideline company method for the asset-based approach which uses publicly traded securities to develop benchmark ratios for pricing, and a multi period discounted future cash flow method for the income approach.

The tax court subsequently rejected both of the parties' valuations as 'deficient and unpersuasive'. The tax court believed that the guideline public companies selected by the IRS for obtaining a value were insufficiently similar to the Company and the income approach contained 'significant errors' and 'suspect' recalculations. The tax court rejected the estate's valuation because it improperly included a 12% Internet and management risk factor in the capitalization rate, erroneously omitted certain non-operating assets, and inflated discounts for minority interest and lack of marketability.

The tax court specifically noted that the lawyer and accountant from Alaska had 'relatively little valuation experience', and it criticized the estate for hiring them to do the valuation, especially in view of the company's New York City headquarters.

Given the lack of confidence in ei-

ther appraiser, the tax court conducted its valuation and obtained a value of \$13.5 million.

The second circuit appeals court disagreed that by rejecting the IRS valuation the court should accept the estate valuation by default. In spite of the necessity of the IRS bearing the burden of having shifted to the IRS to challenge the value in Section 7491, the tax court said that did not mean that it was required "...to adopt the taxpayer's valuation, however erroneous..." The second circuit court said that "...the burden of disproving the taxpayer's valuation can be satisfied by evidence in the record that impeaches, undermines, or indicates error in the taxpayer's valuation." The bench went on to say that the tax court is not bound by formulas or opinions given by expert witnesses, and that it may reach a determination of value "...based on its own analysis of all the evidence in the record."

The second circuit court affirmed the tax court's valuation in all respects but one: the parties agree that the tax court made an error in calculation, specifically with respect to certain non-operating assets and resulted in double counting of income. This, the IRS estimated, created a \$1.2 million overstatement of value in the shares.

With respect to whether a penalty should be imposed, the second circuit court examined if the taxpayer would qualify for a reasonable cause exception for clear error. It stated that it is a question of fact whether elements that constitute reasonable cause are present, but a question of law what elements must be present. The second circuit court said that under agency regulations the existence of reasonable cause must be determined on a case-by-case basis and that the tax court's findings were insufficient to support a determination of reasonable cause. Therefore the second circuit appeals court vacated the tax court's decision not to impose an accuracy-related penalty and remanded the case for a determination as to if the estate's reliance on the Alaska appraisers was reasonable and in good faith.

Proprietary Seller

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meeting of these local deal makers.

“There are several local groups of business men in the Twin Cities,” Schostag said. “This is, to my knowledge, a comparatively recent development. Thirty to 40 years ago when I was starting to get active in corporate finance, I don’t recall this kind of networking.” Schostag cited Meridian and other small business support groups in the Twin Cities, each with unique characteristics, to evidence this growing trend. Mike Bromelkamp, CPA, a Principal of Olsen Thielen & Co., Ltd., which owns MBVG, also cited EBITDA Partners of which he is a member. “We have seven highly qualified individuals who fill unique talent niches in our group,” Bromelkamp said. “These include an accountant, lawyer, marketing specialist, technology advisor, and human resources person, for example. We offer that pool of knowledge to firms with unique needs.”

MBVG Vice President Steve Sarracco said, “We have a strong interest in groups like Fun-d-less Sponsors. They enable MBVG to remain in touch with current buyer and management thinking while they also offer chances for valuation and related corporate finance business.”

In pointing to “Proprietary Sellers” as acquisition candidates and explaining why he considers them ideal, Thomas said that this type of deal offers both parties: (1) More time to measure fit and ‘chemistry’ through the acquisition, (2) Better confidentiality as fewer third parties are aware of the possible transition, (3) A more simplified deal structure and more flexible terms than are usually otherwise available, and (4) A price not bid up by an auction process.

“I have to admit that proprietary deals can also be fickle,” Thomas said. “They involve an almost missionary type of work on the buyer’s part and may even have a

lower probability of success than one represented by an intermediary because in those the seller is qualified and the selling goals have been quantified.”

Thomas and most of the Fun-d-less Sponsors group agreed that the one of the most important but also most subtle determinants in buying a company is handling personal seller issues. “A serious proprietary seller will have their personal issues sorted out before they meet a buyer to consider selling their business,” Thomas said. “In addition, these serious sellers will have a rough exit strategy established in their mind knowing it may take twice as long as they expect.” By identifying early if these issues have been thought through by the seller, Thomas believes that a lot of valuable time can be saved, avoiding deals which fail at the last minutes.”

Thomas asserts that there are eight basic questions which a seller must be able to answer so that the prospective buyer is able to gain assurance that the personal issues have been addressed:

What are the seller’s plans after the sale? Has the seller dreamed about what they will do when they have time and cash in abundance?

Appropriate responses, Thomas believes, are: Italian cooking school, spending time with children and grandchildren, touring Mexico, a return to Vietnam. The worst response, Thomas said, is, ‘I haven’t thought about it. I’m too busy.’

“Without a dream, there is no impetus to sell and your seller will “keep on truckin,” Thomas added. “Ask the seller about the hobbies he or she enjoys and verify them. One seller told me he was going to devote his newfound free time to canoeing in the Boundary Waters of northern Minnesota until he inspected his spider-infested, leaky canoe. His passion for canoeing had not been exercised nor would it be anytime soon.”

How has the seller’s family responded to his / her decision to sell the business?

To get this information Thomas may

ask the seller and their spouse to dinner, ostensibly to hear the tales of owning their own business – their ‘glory days’. “This conversation often helps me determine if the family is supportive of the sale to an outsider. It is commonplace for a spouse outside the business to be the catalyst for the sale of the company,” Thomas said.

Who are the seller’s estate and tax advisors, and are they aware of the seller’s sale plans?

Owners should know how many dollars of disposable income will be left after all the expenses of the sale such as taxes and service providers. “Any surprise to the seller affecting ‘the number’ during the negotiations as a result of the deal structure may strike a deathblow to your proprietary deal,” Thomas said. Tax accountants and estate attorneys are best when used early in the sales process.

How many of the seller’s dollars are at risk if a transaction is not consummated?

Thomas wants to know if that amount at risk is a significant sum. “If the seller has engaged service providers, such as a first time annual audit, legal review, asset appraisals, or an intermediary retainer, they will be more determined to reach a closing,” Thomas said. “They will have to pay service providers for what may be unrecoverable costs. Everyone hates sunk cost, so an investment in service providers is a harbinger of a transaction in the near future.”

Are all the decision makers, partners, and owners at the table for the negotiation?

Unless all stakeholders are involved personally in every negotiation, someone not ‘at the table’ will have the ability to pull the plug on the deal, Thomas said. “Even though there may be a lead negotiator representing the proprietary seller, any time I hear someone say they need to discuss this with their partners, I realize I’m not dealing with all the “right parties”.

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Proprietary Seller

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How long have the seller been considering a sale?

You want to know there is a concrete reason for the sale. Have they reached a certain quantifiable perch, dollars of revenue, number of employees, retirement age, or empty nesting, for example, according to Thomas. "These types of sellers are more committed to a sale because they have reached a goal," Thomas said. "Some sellers cite reasons which are really short term such as a selling due to blips in the business, a poor economy, or an employee lawsuit." These issues may be resolved rather quickly and the owner is then likely to put the business back in gear. "Your time and cost of due diligence will be for nothing," Thomas said.

Are you the first buyers to make an offer?

"I have found the first two buyers to present a term sheet with valuation and terms will not usually win the business," Thomas said. "They are unknowing stalking horses."

Has the seller tried to sell his / her business before?

This is a corollary question to the previous one. What was the reason the previous deal failed, deal structure, personality conflict? The answer to this question, Thomas noted, should reveal previous 'bumps in the road' that should be avoided at all costs.

Schostag observed that in representing a seller a few years ago, his group had managed to obtain a 30% premium for the business from a highly qualified buyer. Yet the deal failed to close at the last minute because the seller decided he couldn't walk away from the business he and his wife had built. "There were hundreds of man hours invested in selling this business, all on a contingent payout," Schostag said. "If we had applied Thomas' rules early in the process, we all could have avoided the wasted time and money."

AICPA SETS VALUATION STANDARDS FOR MEMBERS

The American Institute of Certified Public Accountants (AICPA) has finally issued its new standards for business valuation: Statement on Standards for Valuation Services No. 1 as of June 2007. The statement will be applicable for all valuation engagements after January 1, 2008.

As a subsidiary of Olsen Thielen & Co., Ltd., which is a certified public accounting firm, the Minnesota Business Valuation Group will comply with the new standard, according to Randall Schostag, MBVG President. Schostag is not a Certified Public Accountant (CPA), but he is certified by all of the other valuation certifying bodies. MBVG Vice President Steve Sarracco is a CPA and is also certified by the AICPA for business appraisal.

The staff members of the Minnesota Business Group are now certified by the American Society of Appraisers, the Institute of Business Appraisers, the Chartered Financial Analyst Institute, the National Association of Certified Valuation Analysts, and the AICPA. Schostag said that in most instances work is also compliant with the Uniform Standards of Professional Appraisal Practice (USPAP) to which the American Society of Appraisers subscribes.

The new statement requires any member of the AICPA who does valuation work, including valuing a business or business ownership interest, security, or intangible asset to comply with the statement.

Creating the statement has been surrounded by controversy both within and outside of the accounting profession, according to

Schostag. But Schostag believes that the new standards are good given the increasing number of accountants who are performing business valuation engagements.

The AICPA Consulting Services Executive Committee has written that it hopes the standard will improve the consistency and quality of business valuation practice among AICPA members.

"During the last few years there has been a dramatic increase in the need to do valuations for a variety of reasons," Schostag said. "This increase in demand has brought a number of people in who have done appraisals but who really did not know how to do them.

In a recent tax court matter, for example, the tax court was faced with a valuation done by a lawyer and an accountant, neither of which understood business appraisal. We see this move by the AICPA as a welcome effort to push those who decide to do valuations to at least comply with the basics."

Schostag believes that the move by the AICPA to adopt standards which it can enforce against its members acknowledges the problem of bad appraisals. "This is only one of several changes which have been made for professionals in the last year. We think others will follow."

Schostag pointed to the Pension Protection Act of 2006, highlighted in the November 2006 *Business Valuation Notes* which now requires certified appraisers for certain work.

"There is a growing recognition of the importance of understanding standards and methods which have been tested and been accepted in the industry," Schostag said.

Professional Business Appraisals

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