// KTS
VALUATION ISSUES™
KLARIS, THOMSON & SCHROEDER, INC. 2009-1

Featured Article

"BUT DOC, I FEEL FINE"

WHAT YOU DON'T KNOW ABOUT SELLING YOUR BUSINESS CAN BE DAMAGING

Prepared by: Roger L. Neu, JD, CPA, The M&A Law Firm

If Seller A sells his business for $60M, believing that he received the highest and best bid, he would probably be happy with that result. But what if his business was really worth $80M? Seller A is happy because he doesn't know how much money he left on the table. If you could be one of these "happy" people then this article is not for you. After all, you will "feel fine."

Now for those of you that want to make sure you are not leaving any money on the table, you may want to continue reading. This article explains what you need to do differently outside of the normal M&A process to get added value. Finding this information elsewhere is about as likely as finding a wild polar bear in Mexico.

VALUE is what a seller is looking for. They are not looking for contentious lawyers, arrogant investment bankers, or accountants or auditors that don't understand their business. Value is the result of using the right professionals and conducting the right M&A process. The following five areas address key building blocks that are missing in most M&A transactions.

IN THIS ISSUE

1 **Klaris, Thomson & Schroeder, Inc.**
Featured Article
"But Doc, I Feel Fine"
By Roger L. Neu, JD, CPA

3 **Becker Case**
By John A. Thomson, ASI, MAI

I. <u>PLANNING AND OVERSIGHT</u>. Sellers are excellent at running their business. They, however, do not and should not be expected to know all the nuances associated with selling their business. Just as a neurologist pin points the area of surgery and manages the surgery performed by the neurosurgeon, a seller needs **<u>someone to plan and oversee the entire M&A process.</u>** This includes, the identification of the appropriate members of the M&A team, how to prepare the business for sale, timing and sequencing of marketing, due diligence and closing, and making sure the client understands each phase of the transaction. If sellers understand the process, they can proceed with confidence and are empowered to make better decisions.

> **"Value is the result of using the right professionals and conducting the right M&A process."**

II. <u>HAVING SKILLED PROFESSIONALS AT EACH POSITION.</u> The M&A chain really is only as strong as its weakest link. Sellers should not accept referrals to investment bankers, accountants, consultants or lawyers simply because the referring party is friends with the other party. A good brain surgeon can fail if he does not have a good anesthesiologist. The fact that the anesthesiologist is a friend or has been practicing for a number of years does not necessarily mean he is the person for that particular surgery. Of particular importance in the M&A process is the person or firm that you will use as your investment banker to market the company. That investment banker should have; (i) a good understanding of your industry and business; (ii) the domestic and/or international reach required to find as many potential buyers as possible; (iii) qualified individuals and systems required for your transaction; and (iv) a culture and personnel with personalities that mesh well with the seller. **<u>Often times, an extensive national search will be required to identify the appropriate investment banker.</u>** Sellers should have the opportunity to interview three or more investment bankers before making a decision.

Lawyers with experience and specialization should be used to address each unique area of the transaction. The starting point should be with an M&A attorney that can manage the entire M&A process. Just as you would not use your internist to do your brain surgery, you should not use your general corporate or business attorney to handle your M&A transaction. The M&A attorney managing the process can help you identify the right investment banker and the other specialty lawyers required to complete the transaction. For example, having access to the right environmental lawyer will result in quickly identifying and resolving any environmental problems. The same concept applies in the areas of intellectual property, employee benefits, labor law, international law, tax issues, regulatory matters, insurance coverage, estate

continued on page 2

"But Doc, I Feel Fine"

continued from page 1

and gift planning, immigration, etc., etc., etc. **Even though specialty lawyers may only be needed for a small part of the transaction process, their use will allow sellers to quickly identify problems and resolve those problems in a way that adds value to the business.**

III. UNDERSTANDING HOW YOUR BUSINESS FUNCTIONS. Understanding cause and effect in your business is just as important as the neurosurgeon's understanding of cause and effect in the brain. Sellers commonly conduct a significant part of the M&A process in reverse. Sellers generally wait until after the LOI is signed, and then frantically scramble around to answer all of buyer's due diligence questions uncovering and disclosing the inner workings and financial analysis of their business. Sellers should be proactive at the outset of the M&A process. **The due diligence information should be compiled at the outset of the transaction and not at the end, and compiled in a well laid out "seller due diligence report."**

Buyers want details on seller's product mix, sales and margins along with an analysis of customer revenue and profitability. In addition, buyers want further insight into each of the line items on the balance sheet and income statement (with a detailed "quality of earnings analysis" to show add backs and recast EBITDA). All of this and more shows the "cause and effect" in your business and the "seller due diligence report" is the vehicle to disclose this information.

Having this information available at the outset of the transaction; (i) assists in identifying the right investment banker; (ii) highlights problem areas that can be addressed sooner than later; (iii) takes the burden off the seller of having to dig all of this information out after the LOI is signed; (iv) greatly assists in receiving bids that are more credible since buyers have a much more complete view of the seller before submitting final LOI's; (v) gives seller more credibility in the eyes of buyers; and (vi) speeds up closing since most of the heavy lifting has been done in advance.

Preparation of seller's internal financial statements and the availability of audited seller financial statements also need to be carefully and fully addressed on a case by case basis.

IV. RESOURCES AND NEGOTIATING SKILLS. There are a lot of steps in the sale of a company. Think of climbing a 100 foot stair case with faulty steps and no hand rails. If Seller A wants to get to the $80M step instead of the $60M step, then all of the steps have to be structurally sound and hand rails should be in place all the way to the top. A properly structured "bid template" should be used in soliciting bids. Buyer due diligence should be properly timed and managed to avoid disruption to seller and all agreement terms and conditions should be fully understood and agreed upon. **Seller's agents should be excellent negotiators and have the knowledge and experience to effectively negotiate the best sale terms and conditions.**

V. CLOSING WITH THE BEST POSSIBLE RESULTS. The Closing should be the consummation of fair and hard fought negotiations resulting in mutual respect between the buyer and seller. A bridge should be built between buyer and seller fostering a cooperative, and not an adversarial, relationship. **It is this cooperative relationship of buyer and seller that can avoid many post closing problems.** The M&A process should both build value and then make sure you keep it.

THERE MAY NOT BE ANY WILD POLAR BEARS IN MEXICO AND YOU MAY "FEEL FINE," BUT THERE CAN BE A LOT OF ADDITIONAL VALUE DERIVED FROM THE SALE OF YOUR BUSINESS IF YOU IMPLEMENT AND CARRY OUT THE PROPER M&A PROCESS! ❒

THE M&A LAW FIRM, 2040 MAIN ST., 9TH FLOOR, IRVINE, CALIFORNIA 92614,
(T) (949) 863-1700, (F) (949) 863-1701,
Email: rneuoffice@aol.com,
WEB: www.MandAlawyer.com

The M&A Law Firm was founded by Roger L. Neu, JD, CPA in 1982 to provide specialized M&A legal services to privately held middle market companies ($5M to $250M). Mr. Neu was a CPA with PriceWaterhouse Coopers, graduated from Loyola Law School with honors and has advised over 250 clients in M&A transactions. The M&A Law Firm believes that privately held middle market companies should have the best representation at every step in the M&A process to achieve maximum value.

Becker Case

Covenant Not to Compete,
T.C. Memo 2006-264, Judge Haines

By John A. Thomson, ASA, MAI

Background

Mr. Richard E. Becker, the father ("Mr. Becker") and the Becker family had been engaged in various aspects of the Florida citrus industry since the 1950's. On December 28, 1983, Becker Holding Corporation ("BHC") was incorporated by Mr. Becker for purposes of estate planning and the continuation of the family business.

Mr. Becker was the father of R. William Becker, the son ("William Becker"), Barbara Hurley, daughter and JoAnn Becker, daughter. William Becker was well known in the citrus industry. He was appointed by the Governor of Florida for 2 consecutive, 3-year terms on the Florida Citrus Commission and was elected chairman of the Commission for 5 consecutive years.

As of February 22, 1991, Mr. Becker was BHC's Chairman of the Board. William Becker was BHC's Chief Operating Officer and ran its day-to-day operations, and Barbara Hurley and JoAnn Becker had limited involvement in BHC. The stock of BHC consisted of preferred shares (voting) and common shares (non-voting). Mr. Becker had 863 of the 865 voting shares and the three kids, including William, had the remaining 2 voting shares (1 for William; .5 for each sister). The common shares, non-voting, totaled 2000- of which William had 50% and the two sisters had the balance. Upon the redemption of the preferred (presumably at Mr. Becker's death) the common shares became voting.

BHC was a vertically integrated company that grows harvests and processes citrus fruit. The company directly or indirectly owned 15,410 gross acres of citrus groves and two processing plants with a combined capacity of approximately 18 million boxes per year. The basic products of BHC are frozen concentrated orange and grapefruit juices along with grapefruit and specialty fruit grown for the fresh fruit market.

continued on page 3

Becker Case

continued from page 2

Issue

The sole issue in the case involved what portion, if any, of the consideration paid by Becker Holding Corporation ("BHC") to R. William Becker, son, in redemption of Williams Becker's stock in BHC should be allocated to a covenant not to compete ("CNC"). The implication was an income tax issue. If nothing was allocated to the CNC then William Becker's sale of his stock to BHC would be taxed based on capital gains rates and BHC would not have an amortizable asset. If the CNC was found to be valuable, for example $6.4 million to $14.0 million, then BHC would have a significant amortizable asset and William Becker would pay taxes on the amount allocated to the CNC at the higher ordinary income tax level.

Redemption Agreement

On March 15, 1991, BHC and William Becker entered into an agreement (redemption agreement) which stated in part:

> In consideration of the mutual promises and covenants set forth it is agreed by and between R. William Becker as Seller and Becker Holding Corporation as Buyer as follows:
>
> Price: Seller will sell and buyer will purchase seller's entire common stock of BHC consisting of 1000 shares for $23,953,934 ($23.9 rounded) together with interest at a rate of 10% per year.
>
> Closing and Terms: The closing of this transaction shall occur on April 1, 1991 at which time buyer will pay to seller the down payment of $5.0 million and will execute and deliver a promissory note for the balance of the purchase price.
>
> Termination: Seller's employment with Buyer was terminated as of February 22, 1991 and Seller's authority to act on behalf of the corporation terminated as of that date.
>
> Competition: The seller, R. William Becker, will be free to engage in any and all aspects of the citrus industry, including the growing, picking, and packing of citrus fruit, except that, for a period of three (3) years from closing, Seller shall not directly or indirectly engage in the processing or sale of citrus concentrate or fresh juices; provided further, Seller covenants and agrees that he will not solicit the Company's existing customers or in any way interfere with the company's presently-existing business relationships, nor will he provide to any person, firm or corporation any information concerning the present business of Becker Holding Corporation that is not public knowledge, including, without limitation, the terms of said Company's agreement with Coca-Cola Company or its subsidiaries, the Company's customer lists, the company's marketing strategy, the Company's financial data, or other internal marketing or production information of Becker Holding Corporation. The seller will not in any way take any action that would lead to impairment of the Buyer's currently-existing banking relationships.

At the closing on April 1, 1991, BHC paid William Becker $5 million as a down payment. BHC also executed a promissory note for $18,953,934, payable to William Becker, requiring annual payments of $5 million per year, including interest, on the first day of April each year up to and including April 1, 1996. The promissory note stated in part that, "This note is issued pursuant to that certain agreement dated March 15, 1991 by and between BHC and William Becker with respect to the redemption of the (William Becker's) stock by (BHC)."

No formal appraisals determining the value of BHC or its stock were made prior to the signing of the purchase documents. Mr. Becker and William Becker fixed the price themselves. There was no discussion at the time of the sale about allocating any portion of the consideration to the covenant not to compete.

BHC refused to pay to William Becker the $5 million installment due April 1, 1992, because of its claim that William Becker had materially breached the covenant not to compete. This triggered over 10-years of litigation between father (BHC) and son, William Becker. The litigation ended with the 2006 tax court decision.

Valuation

The issue was the value of the covenant not to compete ("CNC"), if any. However, because the purchase price was freely negotiated and considered Market Value, one approach to the valuation of the CNC was to value the subject 50% non-voting stock. If the value was less than the $23.9 million purchase price, then arguably the gap between the stock value and the purchase price could be a measure of the CNC (GAP Approach). This is how BHC's appraisal firm (MPI) approached the CNC for BHC. MPI's first appraisal was done in 1991 (after the transaction date of April 1, 1991). MPI appraised the stock for $17.5 million leaving approximately $6.4 million for the CNC ($23.9-$17.5). However, in 2005, MPI did a second appraisal and this time appraised the same stock as of the same date at $9.1 million (not an insignificant change from $17.5) leaving approximately $14.0 million for the CNC.

Klaris, Thomson & Schroeder, Inc. ("KTS") also appraised the subject stock of BHC and concluded at $29.1 million , leaving no gap for any CNC. Therefore, based on this approach the CNC would have no value.

KTS also used a more direct approach to valuing the CNC, the income approach. Using a discounted cash flow approach with and without the CNC in place for this 3-year term, and using the income approach, KTS concluded at $2.1 million.

The KTS valuation was based in part on an interview with William Becker, relative to the conditions as of the appraisal date, April 1, 1991. KTS believed that without the CNC, William Becker could present a significant competitive challenge to BHC. However, the question became not whether he would compete, but if he did compete, how effectively he could compete in the 3-year period and in what manner could he compete.

A substantial portion of William Becker's consideration for his stock was being paid over a 5-year period. Although William Becker had the knowledge, experience and was physically capable of competing, would he try to inflict competitive damage on BHC's ability to continue to pay for his stock? Without this compensation for his stock, his ability to compete was financially limited. However, assuming that William Becker decided to compete, what method would he choose to compete? We assumed there were only three possible options:

1. Work for an existing competitor.
2. Build a new processing plant (Greenfield).
3. Acquire and renovate and existing facility.

KTS concluded option number three was the only viable path. Therefore, KTS concluded two indications of value for the CNC:

Residual (Gap Method) - $0 value

Lost Earnings (Income Approach) - $2,100,000

KTS stated in its conclusion of value, "Although the parties' written agreement did not allocate any monetary consideration

continued on page 4

Becker Case

continued from page 3

for the CNC, this in itself does not mean that the CNC has no value. Even though it appeared highly unlikely that William Becker would compete, a prudent buyer would want the added assurance of knowing William Becker would not compete, as William Becker was a key executive of BHC with significant insider information, experience and contact with BHC's customer base."

KTS further stated, "A value towards the low end ($0 value) is supported by the apparent lack of any negotiation between buyer and seller regarding the value of the CNC and the lack of any monetary consideration paid for the CNC. Alternatively, a value towards the upper end ($2.1 million) of the range is supported based on prudent business practices, and economic reasons. KTS concluded at $1.4 million for the CNC.

The Court Concluded the Following:

The purchase documents explicitly and unambiguously allocate the entire $23.9 million of consideration to William Becker's stock. At the time the purchase documents were executed there was no mutual intent to allocate a portion of the consideration to the covenant not to compete. Therefore, we conclude that 100 percent of the consideration paid by BHC to William Becker is allocable to the purchase of William's stock, and none of the consideration to the covenant not to compete.

KTS Comment:

A CNC can be a good short-term (less than 15 years) amortizable asset for a buyer. However, as this decision points out, it should be separately negotiated and there must be mutual intent to allocate a portion of the purchase price to the CNC. Additionally, it should be appraised and a value should be assigned to it in the Acquisition documents. Finally the CNC must also have some economic significance. The party (person or company) agreeing "not to compete" must be reasonably capable of competing. ❐

[1] As valued by Management Planning, Inc. ("MPI") in their first appraisal for BHC in 1991 after the transaction date and in 2005 for $14.0 million in preparation for court.

[2] Williamette was retained by William Becker and concluded the stock was $31.0 million for trial.

is a full service valuation and consulting company specializing in business valuations, intangible asset valuations, financial consulting, expert testimony and litigation support. In addition, we also perform real estate valuations, machinery and equipment valuations, and international transfer pricing analyses.

For more information or a free valuation seminar for your firm or professional group, please call Anita Thomson at (877) 587-7008, or e-mail your request to ktsinc@verizon.net.

"In the business world, the rearview mirror is always clearer than the windshield."
– Warren Buffett

VALUATION ISSUES™
2009-1

KLARIS, THOMSON & SCHROEDER, INC.
Valuation & Consulting Professionals
Los Angeles · St. Louis · Philadelphia
Tampa · Washington, D.C. · Chicago

330 Golden Shore Drive, Suite 200
Long Beach, CA 90802

RETURN SERVICE REQUESTED

PRESORTED
FIRST CLASS MAIL
US POSTAGE PAID
LONG BEACH, CA
PERMIT # 25