

What's It Worth?

A Look at Transactions in the Current Marketplace

Given recent economic ups and downs, many business owners and advisors are curious about merger and acquisition (M&A) activity in the current environment. What's the latest on multiples? What are the done-deal trends these days?

The good news is that merger and acquisition activity is picking up. Banks are finally freeing up capital for the right deals, and things are looking slightly rosier for those interested in buying or selling businesses. Quality deals with strong fundamentals and quality earnings are highly sought after in the transactional marketplace.

The long-term M&A environment is also improving, due primarily to several factors:

- The number of baby boomer business owners ready to retire.
- Market consolidation driven by rapid technology advances.
- Long-term capital growth in the appetite of foreign investors for U.S. companies.
- A buildup of committed capital ready to be put to work at the nation's thousands of private equity firms.

Data to Consider

Transactional data suggests that deal volume has consistently been near pre-recession levels for the past three

quarters, and many observers predict this trend will continue for the near term. Here are a few observations and data points to consider in terms of recent deals:

Multiples are up. GF Data compiles transaction data from 176 private equity firms. The company's second quarter 2011 report includes 1,192 transactions valued from \$10 million to \$250 million, with multiples ranging from 3x to 10x the last 12 months' adjusted EBITDA. The report shows that multiples rose overall from about 5.3x in the first quarter of 2010 to a peak of 6.1x in the first quarter of 2011, then dropped to 5.7x in the second quarter of 2011.

Money is moving. Looking at debt-to-EBITDA ratios, it's clear that credit is not quite as tight as it used to be. For example, GF Data's total debt-to-EBITDA ratios for the first quarter of 2010 were at 2.9x versus 3.2x for the first and second quarters of 2011.

Size matters. The most obvious lesson in the data is that larger companies command a size premium. According to GF Data, since the inception of its database in 2003, for deals with transaction values between \$10 million and \$250 million, the overall average Transaction Enterprise Value (TEV)-to-EBITDA multiple is 6.0x. But smaller deals with a TEV between \$10 million and \$25 million had a TEV-to-

EBITDA multiple of only 5.5x. The multiple on larger deals was higher than average, reaching 7.1x on deals in the \$100 million to \$250 million range.



But it's important to look at the factors included in these ratios. For example, for these same deals, the overall trailing 12-month (TTM) revenue growth averaged 16 percent. For smaller companies in the \$10 million to \$25 million range (average revenues in this group = \$21.8 million), TTM revenue growth is at 13.8 percent. Meanwhile, larger companies in the \$50 million to \$100

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Defined Value Clause Upheld in Gift Tax Case

Tax attorneys and estate tax planners are paying close attention to a recent ruling by the 9th Circuit Court of Appeals. In *Estate of Petter v. Commissioner*, originally litigated in 2009, the court confirmed a trend allowing taxpayers to use a “defined value” clause in gift tax plans.

As a result of this ruling — the third of its kind recently — taxpayers have a new, tax-advantaged way to designate gifts in trust for family members and charities. But even more titillating is the fact that the ruling effectively negates any motivation for the IRS to question the value of gifts designated under this arrangement.

Just the Facts

The case involves Anne Petter, a mother who funded a family limited liability corporation (FLLC) with approximately \$22.6 million of stock and then transferred FLLC membership units to her children’s trusts and two charities.

The complicated transfer basically gifted a dollar amount (\$454,000) of value — not a number of shares of stock — to the trusts, with the remaining value assigned to the charities. However, the key to the allocation was a “defined value” clause, which dictated that the charities were to receive everything over the family gifts’ value of \$454,000 as “finally determined for federal tax purposes.”

An appraisal determined a fair market value of \$536 per unit. The units were transferred accordingly, but a subsequent IRS audit determined that the value should have been \$795 per

the value of additional units transferred as a result of the audit.

Before trial, the parties agreed on a value of \$744 per unit, so that issue was off the table. But the big question still remained: Was Mrs. Petter entitled to a charitable deduction for the value of the additional units transferred according to the defined value clause?

Drumroll, Please ...

The tax court said yes. The IRS appealed. In the appeal, the IRS ditched its “public policy” argument and focused on the idea that the charitable contributions were dependent on a “condition precedent” — an IRS audit — which the tax code prohibits.

The court disagreed, reminding the IRS of its own definition of a condition precedent (one that must occur before a transfer), and expressly told the IRS that if they didn’t like their own definition, they should change it.

Moreover, the court nixed the IRS’s argument about the unit value definition (“as finally determined for gift tax



The court disagreed, pointing out that Mrs. Petter had indeed relied on the fair market value standard as required.

The Bottom Line

Mrs. Petter, her children and the charities won big. But the case rocked the tax world because it removed the IRS’s interest in auditing these arrangements. After all, what would be the point? Even if the IRS disagrees with the valuation, the “defined value” clause ensures that the charities, not the U.S. Treasury, get any excess.

Given this ruling, there’s no question we’ll see much more of the “defined value” clause moving forward. ■

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unit, resulting in a tax deficiency of \$2.1 million. More important, citing “public policy reasons,” the IRS disallowed the defined value clause, which voided the charitable contribution for

purposes”). The IRS claimed that this language indicated a specific dollar amount and that the charities were therefore not entitled to any more units than they initially received.

Interested in finding out more about this case? Contact us for more information.

Are Low Interest Rates Interfering with Valuations?

There's a curious phenomenon occurring in the valuation world. The issue? Unusually low interest rates are resulting in inflated business valuations. Is it OK to "correct" for these aberrant inputs? A lively debate on the topic is currently ongoing in the valuation community.

The Risk-Free Rate

Most income-based approaches to valuation use a discount rate or capitalization rate developed using a "risk-free" interest rate, most often the 10-year or 20-year U.S. Treasury bond yield.

The risk-free rate is a good starting point for cost-of-capital-based valuation methods because it represents the rate of return an investor would earn with the "safest" type of investment — in this case, government bonds. To calculate the value of a company, the analyst starts with this risk-free rate and adds in an equity risk premium along with premiums for other factors based on various characteristics of the target business.

Generally, government bonds move in a reasonable manner with respect to the market. But in the fall of 2008 — the beginning of the "Great Recession" — yields reacted dramatically. In October 2008, 20-year T-bond yields were at 4.74 percent but, a month later, they dropped all the way to 3.05 percent.

"Flight to Quality"

Investment analysts characterized this drop as a "flight to quality." In other words, as the market dropped in the fall of 2008, investors sought less volatile, "safer" holdings, including government bonds. And thanks to the law of supply and demand, as bonds became more appealing, their prices went up and their yields dropped.

The problem in a business valuation is that higher value is normally associated with lower risk. So, assuming all the other factors used in a valuation calculation stay the same, if the risk-free rate drops a couple of percentage points, it actually results in a higher

business value. This obviously doesn't make sense in a period of extreme market volatility.

Change the Model?

While these inflated valuations make some business owners very happy, they are not realistic. Therefore, they present skewed expectations in the marketplace. As expected, some valuation analysts now argue that steps must be taken to adjust valuations in times of flight to quality.

One respected valuation expert, Roger Grabowski, posits that if the 20-year T-bond yield is unusually low, it shouldn't be used as the risk-free rate. As a more realistic alternative, Grabowski suggests that analysts use an approach to estimate a "normalized" risk-free rate in times of flight to quality.

However, other valuation analysts are distressed at this suggestion, believing that the current risk-free rate

should remain the standard, despite economic times. They note that, by definition, a valuation is done as of a certain date, so regardless of the state of the economy, typical valuation assumptions should stand.

Other options would be to show an adjustment separately based on the current aberration in the economic situation, or to adjust the specific company premiums added to the risk-free rate to accommodate the unusually low yields.

It's no surprise these models only get tested in this manner during times of extreme volatility. Yet another reason to hope for a more moderate, steady and reasonable economy! ■

Our experienced analysts are well versed in the details and nuances of various valuation methods. Let us help you with your valuation needs.

Current Marketplace Transactions

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million TEV range (average revenues in this group = \$77.7 million) boast TTM revenue growth of 19.2 percent. Growth rates clearly impact value and multiples.

Debt varies. Debt-to-EBITDA also varies by TEV: Larger deals will support a higher amount of debt. For example, in the second quarter of 2011, for companies with TEV of \$100 million to \$250 million, the debt-to-EBITDA ratio was 3.7x, versus 3.1x for deals in the \$10 million to \$25 million range. These debt multiples also impact the amount of equity required to get a deal done. For deals closed in the first half of 2011, the average equity contribution was 47.4 percent — a continued decline from an average equity share of 51.1 percent required in 2010.

What Does It Mean?

What can we learn from these numbers? For one thing, deals are getting done, so it's not a bad time to consider buying or selling a business. But valuation multiples vary by industry and by specific company fundamentals. Each company is different. Size, industry, growth rate, EBITDA margin, equity, debt and many other factors combine to create an appropriate multiple for each transaction. ■

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Now Is the Time to Act on Gift and Estate Planning

Is your estate plan up to date? There's just one more year left before the estate tax exemption amount drops from \$5 million to just \$1 million.

To recap: The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 temporarily upped the estate tax exemption to \$5 million per person for 2011 and 2012. The lifetime gift tax exemption also jumped to \$5 million for these two years.

In 2013, absent any legislative action, the estate tax and gift tax exemption will revert to \$1 million. Also, the maximum estate and gift tax rate is 35 percent for 2012, but will climb to 50 percent in 2013 (again, assuming no congressional action). For most gifts made to (or in trust for) grandchildren, the gen-

eration skipping tax rate for 2012 is also 35 percent, but jumps to 55 percent in 2013.

Any Exemption Left?

Given this rare window of opportunity, now is the time to take full advantage of the higher estate tax exemption. Remember, even if you have a sound, well-designed estate and gift plan, the plan may have been created several years ago when the estate tax exemption was just \$1 million.

If so, you have \$4 million more in exemption to work with this year, and relatively favorable tax rates as well. Many individuals and families are revisiting their estate and gift plans with these new figures in mind — and plan-

Now is the time to take full advantage of the higher estate tax exemption.

ning to act aggressively to take full advantage of the higher exemption levels.

With business valuations relatively low due to the economy, it may be worthwhile to consider a major transfer of business shares to your heirs this year as well. Of course, all of these decisions should be made in the context of your succession plan and with the input of your trusted advisors. ■

Please contact us to discuss revisiting your existing estate plan or creating a new one.



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