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Organismo Italiano di Valutazione
Business Valuation International Conference

Control Premiums in Financial Reporting

Presented by:

Carla G. Glass, CFA, FASA, FRICS

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Disclaimer

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- The views expressed do not necessarily represent the views, positions, or opinions of any organization referenced in the material or HSSK
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- Special thanks to Dayton Nordin (E&Y) and Travis Harms (Mercer Capital) for allowing me to recycle many of their slides

Today's Presentation

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Background

Why does it matter?

Overview of WG3 Efforts

What are we doing?

Example

Putting theory into practice

Q&A / Discussion

BACKGROUND

WHY DOES IT MATTER?

Why the Focus on Control Premiums?

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US Securities and Exchange Commission (SEC) focus

Equity market volatility

Diversity of practice

A Sample of SEC Comments

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…we have read your response to comment 7 in our letter dated June 30, 2009. In future filings, please ensure you disclose the basis for why a control premium of between 35% and 40% of market capitalization is reasonable...

…If you included a control premium in a goodwill impairment evaluation utilizing the quoted market price of your common shares, please tell us how you determined that control premium and why you believe the assumed premium is appropriate in your circumstances.

December 2008 Speech by Robert Fox (SEC)

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...the amount of a control premium in excess of a registrant's market capitalization can require a great deal of judgment. Contrary to some rumors I have heard, the staff does not have "bright line" tests…

…an important factor to consider is their recent trends in market capitalization…in volatile markets, and other unique circumstances, it may not always be reasonable to look at a single day's market capitalization…

…[a control premium] based on an arbitrary percentage determined by a "rule-of-thumb" would not appear to be well reasoned…

Equity Market Volatility

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Diversity of Practice

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Consensus within the profession has been elusive

- Eric Nath – BVR 1990
- Michael Bolotsky – BVR 1991
- M. Mark Lee – BVU 2001
- Aswath Damodaran – 2005

Different contexts:

- US income tax versus financial reporting

OVERVIEW OF "WORKING GROUP 3" EFFORTS

WHAT ARE WE DOING?

The Appraisal Foundation

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The Appraisal Foundation Working Groups – Best Practices in Valuations for Financial Reporting

- The Identification of Contributory Assets and Calculation of Economic Rents (the Contributory Asset Charge, or CAC, document)
- The Valuation of Customer-Related Assets
- Control Premiums
- Contingent Consideration

Efforts that Address Control Premiums

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Appraisal Foundation Third Working Group – Control Premiums

- For business valuation – primarily impairment
- Step transactions
- Investment company issues

AICPA – Impairment Task Force

- Focus on premiums as it relates to testing for impairment of reporting units

AICPA – Valuation of Privately Held Company Equity Securities Issued as Compensation

Considerations

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Different standards of value exist for different valuation purposes

In financial reporting - depends on both the unit of account and the inputs used in the valuation

Refer to the appropriate standards that specify the unit of account for each asset or liability when thinking about control premiums

Appraisal Foundation Third Working Group

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Members:

Manish Choudhary – Deloitte Financial Advisory Services LLP

Andrew Fargason – Stout Risius Ross, Inc.

Travis Harms – Mercer Capital

Dayton Nordin – Ernst & Young, LLP

Robert J. Orzechowski – KPMG, LLP

TAF Oversight and Facilitator:
Carla Glass – Hill Schwartz Spilker Keller LLC

Special Thanks to Dayton Nordin and Travis Harms for allowing me to recycle their slides

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Working draft due to be released soon

Focuses on the concept of control premiums when measuring fair value for financial reporting purposes. It will not address:

- Premiums in other contexts such as tax or disputes
- Discounts for lack of control

Expected to focus on control premiums when considering:

- Impairment
- Investment company holdings
- Step transactions

Core Messages

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A control premium describes the relationship between two values – it defines neither

For a control premium to exist, prerogatives of control must give rise to economic benefits

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What is a control premium?

- A fairly controversial concept
- Some would argue that it doesn’t really exist or is rare

Some of the prerogatives of control include:

- The ability to make all management decisions
- The ability to benefit from synergies available through combinations with other entities
- The ability to change the cost of capital to the entity by changing the capital structure
- Reducing the cost of capital due to achieving greater diversification, size and access to capital

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The monograph introduces the term Market Participant Acquisition Premium (MPAP)

Differentiates those elements of value above marketable non-controlling share value that are appropriately included in the Fair Value of a controlling interest for financial reporting

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The MPAP Definition:

It is the difference between (i) the *pro rata* fair value of the subject controlling interest and (ii) its Foundation value

- For publicly traded companies, Foundation value is the quoted market price for the company's shares
- For entities whose shares are not publicly traded, Foundation value is measured with respect to the current stewardship of the entity – contemplates that the prerogatives of control continue to reside with the existing controlling shareholder(s). It is often what is referred to as the *pro rata* marketable, non-controlling value

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Fundamental perspectives of the group

- Prices paid for control of entities can reasonably reflect the economic benefits the buyers expect from ownership of control of the entity

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Fundamental perspectives of the group

- Quantification of economic benefits typically focuses on:
  - Cash flow impacts
    - Enhanced growth,
    - Increased margins,
    - Working capital and capital expenditure efficiencies
  - Reduced Risk
    - Greater size and diversification of the post-acquisition company
    - Buyer has better access to less costly capital
    - Optimizing the financing mix of a company

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Fundamental perspectives of the group

- The market participant, a rational buyer, will pay no more than necessary to outbid the next most aggressive bidder for a given investment opportunity
- Bidder interest matters: where bidder interest is low, the market price is less likely to reflect significant MPAP benefit, but where there is robust bidder interest, the price may reflect a higher portion of the available benefits of the MPAP
- In no case is a market participant willing to pay an amount that exceeds the value of the maximum cash flows that can be generated through the business combination
- In addition, control is often expressed on a spectrum and can also be applicable when an entity has significant influence over another entity

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Fundamental perspectives of the group

- An entity might have a greater value after an acquisition than it has under current management
- The Working Group also believes that premiums for control may not always be warranted
- If current management is already operating in a manner that is similar to the value that would reasonably be achieved after an acquisition, then the value before and after acquisition would reasonably be similar

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Fundamental perspectives of the group

- The extent of analysis of the MPAP should reflect the importance of the premium to the analysis
- A benchmark control premium resulting from the analysis of comparable transactions is viewed as either a starting point or a check for reasonableness
- Detailed analysis of the enhanced cash flows attributable to control provides the best form of support for control premiums

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Examples of items to consider when studying MPAP:

- Who are the market participants (strategic, financial, etc.)
- Size of market participants vis-à-vis target
- Stage in life cycle of subject entity
- State of industry acquisition activity
- Growth rate of peer companies
- Margins of peer companies
- Balance of information
- Capital structure of the target company
- Perceived quality of management
- Contingent consideration
- Regulatory factors

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EXAMPLE

THEORY INTO PRACTICE

Example: Subject Company Background

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Abbreviations on following slides:

Enterprise = Total Invested Capital

EV = Enterprise Value = Value of Total Invested Capital

EBITDA = Earnings Before Interest expense, Taxes, Depreciation, and Amortization

Example: Subject Company Background

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The enterprise value of the subject company on a marketable non-controlling basis is $4,715 (equity value of $3,000)

Expected 5-yr Compound Annual Revenue Growth	6.5%
Gross Profit Margin	60.0%
Operating Expenses:	
Research & Development	5.0%
Distribution Expenses	14.5%
Selling Expenses	17.5%
Other General & Administrative	7.5%
EBITDA Margin	15.5%
Weighted Average Cost of Capital	10.0%
Marketable Non-Controlling Multiples	
EV / Trailing Revenue	0.8
EV / Trailing EBITDA	5.1

Example: Subject Company Background

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The enterprise fair value of the subject company on a controlling interest basis is $6,354 (equity value of $4,638)

Enterprise Value	**$6,354**
Interest-Bearing Debt	1,716
Equity Value	$4,638
Shares Outstanding	300.0
Fair Value per Share	$15.46
Trading Price per Share	$10.00
MPAP (Equity)	54.6%
MPAP (Enterprise Value)	34.7%

Is market participant acquisition premium reasonable?

Excursus: Measuring the MPAP

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The Working Group believes that measuring the MPAP on an enterprise basis is more consistent with the underlying factors influencing the premium

	Marketable Non-controlling	Fair Value
Enterprise Value	**$4,715**	**$6,354**
Interest-Bearing Debt	1,716	1,716
Equity Value	$2,999	$4,638
Shares Outstanding	300.0	300.0
Fair Value per Share	$10.00	$15.46
MPAP (Equity)		54.6%
MPAP (Enterprise Value)		**34.7%**

Example: Non-Controlling Value (DCF)

EXHIBIT A
Market Participant Perspective - Minority Interest

Compound Annual Growth Rate (Revenue, Year 5): 6.5%

	Trailing		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Residual
Revenue	$6,000		$6,450	$6,902	$7,350	$7,791	$8,220	$8,631	$9,019	$9,380	$9,708	$9,999	$10,298
Revenue Growth			*7.5%*	*7.0%*	*6.5%*	*6.0%*	*5.5%*	*5.0%*	*4.5%*	*4.0%*	*3.5%*	*3.0%*	*3.0%*
Gross Profit	3,600	60.0%	3,870	4,141	4,410	4,675	4,932	5,178	5,411	5,628	5,825	6,000	6,179
Operating Expenses:													
Research & Development	300	5.0%	323	345	368	390	411	432	451	469	485	500	515
Distribution Expenses	870	14.5%	935	1,001	1,066	1,130	1,192	1,251	1,308	1,360	1,408	1,450	1,493
Selling Expenses	1,050	17.5%	1,129	1,208	1,286	1,363	1,438	1,510	1,578	1,641	1,699	1,750	1,802
Other General & Administrative	450	7.5%	484	518	551	584	616	647	676	703	728	750	772
Total Operating Expenses	2,670	44.5%	2,871	3,072	3,271	3,467	3,657	3,840	4,013	4,173	4,320	4,450	4,582
EBITDA	**930**	**15.5%**	**999**	**1,069**	**1,139**	**1,208**	**1,275**	**1,338**	**1,398**	**1,455**	**1,505**	**1,550**	**1,597**
Depreciation & Amortization	286		286	302	337	377	412	451	478	513	540	562	581
EBIT	644		713	767	802	831	863	887	920	942	965	988	1,016
Taxes	258	40.0%	285	307	321	332	345	355	368	377	386	395	406
Debt Free Net Income	386		428	460	481	499	518	532	552	565	579	593	610
Incremental Working Capital		30.0%	135	135	135	132	129	123	117	108	98	87	90
Depreciation & Amortization			286	302	337	377	412	451	478	513	540	562	581
Capital Expenditures			286	400	450	500	525	541	557	574	591	609	627
Debt Free Cash Flow			293	227	233	244	276	319	356	396	430	459	474
Residual Value													6,800
Discounting Periods			0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5	9.5
PV Factor	10.0%		0.9535	0.8668	0.7880	0.7164	0.6512	0.5920	0.5382	0.4893	0.4448	0.4044	0.4044
PV DFCF			279	197	184	175	180	189	192	194	191	186	2,750

Enterprise Value	**$4,715**
Interest-Bearing Debt	1,716
Equity Value	$2,999
Shares Outstanding	300.0
Fair Value per Share	$10.00
Trading Price per Share	$10.00
MPAP (Equity)	0.0%
MPAP (Enterprise Value)	0.0%

Residual Value Calculation		
Residual Debt Free Cash Flow		474
Cost of Capital	10.0%	
Estimated Residual Growth Rate	3.0%	
Residual Capitalization Rate		7.0%
Residual Value		6,800

Example: Fair Value Measurement (DCF)

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EXHIBIT B

Market Participant Perspective - Controlling Interest

Compound Annual Growth Rate (Revenue, Year 5): 8.0%

	Trailing		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Residual
Revenue	$6,000		$6,600	$7,194	$7,770	$8,313	$8,812	$9,253	$9,623	$9,960	$10,259	$10,566	$10,882
Revenue Growth			*10.0%*	*9.0%*	*8.0%*	*7.0%*	*6.0%*	*5.0%*	*4.0%*	*3.5%*	*3.0%*	*3.0%*	*3.0%*
Gross Profit	3,600	60.0%	3,960	4,316	4,662	4,988	5,287	5,552	5,774	5,976	6,155	6,340	6,529
Operating Expenses:													
Research & Development	300	5.0%	330	360	388	416	441	463	481	498	513	528	544
Distribution Expenses	870	13.5%	891	971	1,049	1,122	1,190	1,249	1,299	1,345	1,385	1,426	1,469
Selling Expenses	1,050	17.5%	1,155	1,259	1,360	1,455	1,542	1,619	1,684	1,743	1,795	1,849	1,904
Other General & Administrative	450	7.0%	462	504	544	582	617	648	674	697	718	740	762
Total Operating Expenses	2,670	43.0%	2,838	3,094	3,341	3,575	3,790	3,979	4,138	4,283	4,411	4,543	4,679
EBITDA	**930**	**17.0%**	**1,122**	**1,222**	**1,321**	**1,413**	**1,497**	**1,573**	**1,636**	**1,693**	**1,744**	**1,797**	**1,850**
Depreciation & Amortization	286		286	302	337	377	412	451	478	513	540	562	581
EBIT	644		836	920	984	1,036	1,085	1,122	1,158	1,180	1,204	1,235	1,269
Taxes	258	40.0%	334	368	394	414	434	449	463	472	482	494	508
Debt Free Net Income	386		502	552	590	622	651	673	695	708	722	741	761
Incremental Working Capital		30.0%	180	178	173	163	150	132	111	101	90	92	95
Depreciation & Amortization			286	302	337	377	412	451	478	513	540	562	581
Capital Expenditures			286	400	450	500	525	541	557	574	591	609	627
Debt Free Cash Flow			322	276	304	336	388	451	505	546	581	602	620
Residual Value													9,100
Discounting Periods			0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5	9.5
PV Factor	9.8%		0.9543	0.8692	0.7916	0.7209	0.6566	0.5980	0.5446	0.4960	0.4517	0.4114	0.4114
PV DFCF			307	240	241	242	255	270	275	271	262	248	3,744

Enterprise Value	**$6,354**
Interest-Bearing Debt	1,716
Equity Value	$4,638
Shares Outstanding	300.0
Fair Value per Share	$15.46
Trading Price per Share	$10.00
MPAP (Equity)	54.6%
MPAP (Enterprise Value)	34.7%

Residual Value Calculation		
Residual Debt Free Cash Flow		620
Cost of Capital	9.8%	
Estimated Residual Growth Rate	3.0%	
Residual Capitalization Rate		6.8%
Residual Value		9,100

Example: Economic Factors

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Comparison of assumptions reveals three primary factors influencing MPAP:

- Enhance revenue due to larger distribution networks of potential acquirers
- Enhanced margins due to cost savings in distribution and overhead
- Lower cost of capital due to size considerations

	Marketable Non-controlling	Fair Value
Expected 5-yr Compound Annual Revenue Growth	6.5%	8.0%
Gross Profit Margin	60.0%	60.0%
Operating Expenses:		
Research & Development	5.0%	5.0%
Distribution Expenses	14.5%	13.5%
Selling Expenses	17.5%	17.5%
Other General & Administrative	7.5%	7.0%
EBITDA Margin	15.5%	17.0%
Weighted Average Cost of Capital	10.0%	9.8%
Enterprise Value	$4,715	$6,354
EV / Trailing Revenue	0.8	1.1
EV / Trailing EBITDA	5.1	6.8

Example: Economic Factors

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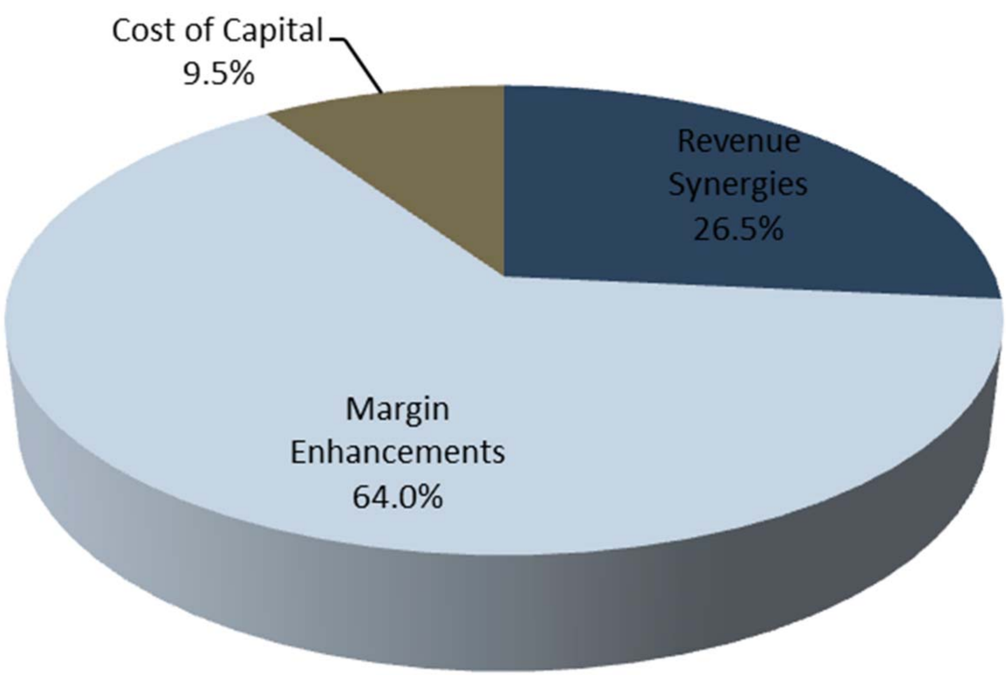
Each of these potential sources of market participant acquisition premium can be isolated



Example: Assessing Revenue Synergies

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How do the assumed market participant growth rates compare to guideline companies?

Factors that might be particularly relevant for revenue considerations

- Who are the market participants (strategic, financial, etc.)**
- Size of market participants vis-à-vis target**
- Stage in life cycle of subject entity**
- State of industry acquisition activity
- Growth rate of peer companies**
- Margins of peer companies
- Balance of information
- Capital structure of the target company
- Perceived quality of management
- Contingent consideration**
- Regulatory factors

Example: Assessing Margin Enhancement

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Going back to the factors discussed previously, items that might be particularly relevant for margin considerations

- Who are the market participants (strategic, financial, etc.)**
- Size of market participants vis-à-vis target**
- Stage in life cycle of subject entity**
- State of industry acquisition activity
- Growth rate of peer companies
- Margins of peer companies**
- Balance of information
- Capital structure of the target company
- Perceived quality of management**
- Contingent consideration
- Regulatory factors

Example: Assessing Margin Enhancement

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How does the assumed market participant margin compare to guideline companies?

Market Participant (Control)	17.0%
Market Participant (Minority)	15.5%
Margin Enhancement	1.5%
Company A	18.0%
Company B	17.5%
Company C	19.0%
Company D	17.0%
Company E	13.0%

Example: Assessing Cost of Capital Effects

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Going back to the factors discussed previously, items that might be particularly relevant for cost of capital effects

- Who are the market participants (strategic, financial, etc.)**
- Size of market participants vis-à-vis target**
- Stage in life cycle of subject entity
- State of industry acquisition activity
- Growth rate of peer companies
- Margins of peer companies
- Balance of information
- Capital structure of the target company**
- Perceived quality of management
- Contingent consideration**
- Regulatory factors **

Example: Assessing Overall Reasonableness

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Does comparison of the implied multiples to the guideline public companies reveal a coherent narrative?

	LTM Revenue	LTM EBITDA	Projected EBITDA Margin	Est. 5-Yr Revenue Growth	Market Value (Total Capital)	MVTC / Revenue	MVTC / EBITDA
Company A	$29,000	5,220	18.0%	6.0%	$31,320	1.08	6.0
Company B	$5,100	893	17.5%	10.0%	$6,248	1.23	7.0
Company C	$13,200	2,508	19.0%	7.2%	$13,794	1.05	5.5
Company D	$2,400	408	17.0%	5.0%	$2,040	0.85	5.0
Company E	$9,000	1,170	13.0%	-2.0%	$5,265	0.59	4.5
MEDIAN	**$9,000**		**17.5%**	**6.0%**		**1.05**	**5.5**
AVERAGE	**$11,740**		**16.9%**	**5.2%**		**0.96**	**5.6**
Subject Company							
Non-controlling	$6,000	930	15.5%	6.5%	$4,715	0.79	5.1
Fair Value	$6,000	930	17.0%	8.0%	$6,354	1.06	6.8

Example: Assessing Overall Reasonableness

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Does comparison of the implied multiples to comparable transactions make sense?

	LTM Revenue	LTM EBITDA	EBITDA Margin	Est. 5-Yr Revenue Growth	Transaction Value (Enterprise)	MVTC / Revenue	MVTC / EBITDA
Company F	$4,500	788	17.5%	4.0%	$5,513	1.23	7.0
Company G	$7,800	1,248	16.0%	8.0%	$9,360	1.20	7.5
Company H	$9,000	1,170	13.0%	5.0%	$7,020	0.78	6.0
MEDIAN	**$7,800**		**16%**	**5.0%**		**1.20**	**7.0**
AVERAGE	**$7,100**		**16%**	**5.7%**		**1.07**	**6.8**
Subject Company							
Fair Value	$6,000	930	17.0%	8.0%	$6,354	1.06	6.8

Example: Assessing Overall Reasonableness

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Is comparison to observed control premiums compelling?

Guideline Control Premiums

	Transaction Price Per Share	Shares Outstanding	Transaction Value (Equity)	Interest Bearing Debt	Transaction Value (Enterprise)	Unaffected Price Per Share	Observed Control Premium (Equity)	Observed Control Premium (Enterprise)
Company F	$36.50	55.1	$2,013	3,500	$5,513	$30.00	21.7%	7.0%
Company G	$61.00	153.4	$9,360	0	$9,360	$45.00	35.6%	35.6%
Company H	$25.00	280.8	$7,020	0	$7,020	$15.75	58.7%	58.7%
MEDIAN							**35.6%**	**35.6%**
AVERAGE							**38.7%**	**33.7%**
Subject Company								
Fair Value	$15.46	300.0	$4,638	1,716	$6,354	$10.00	54.6%	34.7%

Usefulness of Historical Aggregates?

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One Industry, One Year

- 12 Transactions with known premiums
  - Premiums range from 17.8% to 300.0%
  - Average 76%
  - Median 59%
- 4 of these Transactions known to have closed
  - Premiums range from 39.7% to 105.0%
  - Average 68%
  - Median 63%

Is Control Premium Data Valuable?

Maybe…

- Provides a composite view of the control benefits perceived (and paid for) by acquirers
- Helps establish the reasonableness of cash flow benefits assumed (or implied) by fair value measurement

… but the data cannot be relied on blindly

- Lots of unknown factors underlying each transaction
- Relative financial performance likely unknown
- Implied multiples might be of interest

Q&A / DISCUSSION

HILL SCHWARTZ SPILKER KELLER LLC
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Carla G. Glass, CFA, FASA, FRICS

Partner

Hill Schwartz Spilker Keller LLC

Two Lincoln Centre

5420 LBJ Freeway • Suite 610

Dallas, Texas 75240

214.741.5360 ext. 103

cglass@hssk.com

www.hssk.com