The McLean Group
INVESTMENT BANKING

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The McLean Group's Valuation Practice

As a core competency and complement to its mergers & acquisitions (M&A) practice, The McLean Valuation Services Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes.

Putting Embedded Features (and derivative instruments) to Bed – The Impact of EITF 07-5

The world of U.S. financial accounting is a dynamic landscape that is constantly evolving. The Financial Accounting Standards Board's ("FASB's") issuance of EITF 07-5 "Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity's Own Stock" is a clear example of just how ever-changing the environment can be. This particular guidance issued by the Emerging Issue Task Force seeks to clarify the underlying requirements for determining whether or not an equity-linked instrument or embedded feature is indexed to an entity's own stock. More specifically, EITF 07-5, which is effective for fiscal years beginning after December 15, 2008, employs a two step process that analyzes an instrument's contingent exercise (if any) provisions and settlement provisions.

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The Downer of "Down Round" Financing

When a red hot economy turns bad, many existing investors are faced with the decision between going out of business or diluting their ownership through a "down round" of financing. Down round financing is a round of financing where investors purchase stock from a company at a lower value than the value placed upon the company by earlier investors. The devaluation of the company stock is necessary to attract funding to continue operations, but results in dilution of ownership for existing owners.

The lower valuation placed in the company can be extremely dilutive to other shareholders, if investors do not structure down round anti-dilution protection.

Down round anti-dilution protection is incorporated into the terms of many preferred stock purchase agreements to provide existing investors with additional stock if the company issues new shares at a price below the price paid by existing shareholders. This protection is typically structured in two ways, weighted average and full-ratchet. Both of these are designed to protect the investor against decreases in the company's value.

The anti-dilution protection in both scenarios is achieved by having the conversion price, typically the original price paid, adjusted downward upon a down round issuance at less than the current conversion price, such that the original investors will receive extra shares of common stock upon

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"The Impact of EITF 07-5..." continued from p. 1

The purpose of this particular EITF is to provide guidance regarding the determination of whether or not an equity-linked instrument or embedded feature is directly indexed to an entity's stock. This is important as it plays a role in establishing the correct accounting classification of the instrument or embedded feature as equity or a derivative, which can have an impact on an entity's financials.

EITF 07-5 is expected to impact many private companies, especially ones with preferred stock. These firms typically employ the usage of anti-dilution provisions for their rounds of financing. According to EITF 07-5, instruments with down-round protection provisions are not indexed with an entity's own stock, as none of the down-round variables are inputs to the fair value calculation of the instrument. In addition, many convertible instruments subject to such anti-dilution provisions will have to be separated between its respective components with the conversion portion of the instrument being recognized separately as a derivative.

Step 1 – Evaluate the Instrument's Contingent Exercise Provisions, if any.

The first step in determining whether or not an equity-linked instrument or embedded feature is indexed to an entity's own stock is identifying any exercise contingencies that would trigger the right to exercise the underlying instrument or feature. EITF 07-5 indicates that an instrument or feature would pass Step 1 if the contingency is based on:

1) An observable market for the issuer's stock; or

2) An observable index calculated or measured by the issuer's own operations, possibly in the form of a performance metric, such as revenue, EBITDA, net income, or total equity.

If the underlying instrument or embedded feature meets the requirements listed above, it is necessary to proceed to Step 2 of the analysis. If the exercise contingency does not meet the above specifications, the instrument is not considered indexed to an entity's stock and would not be classified as an equity instrument.

Step 2 – Evaluate the Instrument's Settlement Provisions

The second step required for EITF 07-5 is analyzing the settlement provisions for the instrument or embedded feature. More specifically, according to EITF 07-5, "an instrument (or embedded feature) would be considered indexed to an entity's own stock if the settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount or a fixed amount of debt issued by the entity." The aforementioned requirement describes a "fixed-for-fixed" type of instrument, in which the counterparty has the right to purchase a fixed number of shares at a fixed price or for a fixed principal amount of a debt instrument. It is important to note that there are exceptions to the rule, as instruments subject to subsequent adjustments (settlement price and/or number of exercise shares are not fixed) could possibly still be considered indexed to an entity's stock. According to EITF 07-5, if the variables that could impact the settlement amount would be inputs in the fair value calculation, such as an option-pricing model, the instrument or embedded feature would still be considered indexed to the entity's stock.

As EITF 07-5 became effective for fiscal years beginning after December 15, 2008, it is subject to prospective application for all outstanding instruments. Therefore, it's possible for instruments that were previously classified as equity to be designated as derivatives once EITF 07-5 has been applied. Instruments and/or embedded features that are ultimately classified as derivatives (are not indexed to an entity's own stock) will need to be recorded at their fair values on the effective date of EITF 07-5 application. It is important for management to be aware of this nuance, as any subsequent changes in the fair value of these instruments would be recognized on the entity's income statement. ◆

"Downer of "Down Round..." continued from p. 1

the conversion of the preferred stock for no additional consideration. The more traditional protection, weighted-average, results in an adjustment to the conversion price based on the average issuance price. The full-ratchet protection provisions gained more traction after the tech bubble in 2001, and is potentially far more dilutive than the weighted-average. It protects investors by adjusting the conversion price to the lowest price per share at which the company sold shares in the down round, regardless of the number of shares issued.

If the preferred shareholders are protected, then what happens to the common shareholders investment? The existing common shareholders, who are already watching the value of their investment decrease with the company's performance, will most likely face further dilution and devaluation in a down round of financing.

Down round financing can create a perception of unfair dealing based on a number of factors, including potential conflicts of interest of the board of directors and the perceived leverage of the original financial investors. Therefore, it is essential that board members understand the financial terms and fiduciary duties in a down round, and take steps to limit any potential for any director liability. ◆

Spotlight on Court Cases

Sunbelt Beverage Corp. Shareholder Litigation, 2009 Consol. C.A. No. 16089-CC
In Sunbelt Beverage Corporation Shareholder Litigation the Fair Value of Jane Goldring's, the Plaintiff's, minority interest in Sunbelt is disputed. The per share value from the experts' opinions vary between $45.83 from the Defendant's expert to $114.04 per share from the Plaintiff's expert. Chancellor Chandler analyzed the appropriateness of each of the valuation methodologies used to determine the per share price of Sunbelt. The Fair Value of Sunbelt Beverage Corporation at the time of merger was determined to be $114.04 per share in favor of the Plaintiff. Although, the Chancellor accepted the discounted cash flow analysis methodology, he had significant issues with the discount rate. Specially, he adjusted the small-firm risk premium and specific company risk premium.

The first issue of small-firm risk premium begged the question of circularity. The Chancellor debated which should come first, the valuation of the company or the selection of the Ibbotson risk premium. The decision was made to follow the strict language of the Ibbotson SBBI book and a premium of 3.47% was applied for companies in the ninth or tenth deciles, which is the weighted balance between the ninth-decile and the tenth-decile premium. The Chancellor believed this accounted for the possibility that the company's valuation is on either side of the line and that Ibbotson itself applied to all firms within the ninth and tenth deciles.

The second issue of importance is the appropriateness of the company-specific risk premium, which bears a burden of proof. Chancellor Chandler described the way that judges view company-specific risk premium: "to judges, the company specific risk premium often seems like the device experts employ to bring their final results in line with their clients' objectives, when other valuation inputs fail to do the trick." The justifications used were not sufficient, therefore the Chancellor ruled out the use of the specific-company risk in the analysis. The Chancellor stated that "it is important for any proposed company-specific risk premium to be based on a specific financial analysis, so that the Court can verify both the propriety of including the risk premium and the appropriate level of the premium." Due to the failure of the Defendant to meet the requirements and provide reasoning for the company-specific risk, no adjustments to the calculation of Sunbelt's Fair Value per share were made.

Miller Bros. Coal v. Consol of Kentucky, Inc, 2009 WL 4904032 (Bkrtcy. E.D. Ky.) (Dec. 11, 2009)
In the case of Miller Bros. Coal vs. Consol of Kentucky, Inc., the Plaintiff claimed lost profits and damages totaling $10.2 million due to a breach of contract by the defendant. The Defendant declared a force majeure (an event that is beyond reasonable control of the parties and cannot be avoided, caused by overpowering, superior, or irresistible force) under the parties' contract mining agreement due to the economic downturn in 2009. The court ruled that the coal mining agreement ("CMA") never suffered a force majeure and merely experienced normal market conditions and risks associated with the coal mining industry. Therefore, the court decided on the appropriate damages to award the Plaintiff. The measure of damages for breach of contract was "that sum which will put the injured party into the same position he would have been in had the contract been performed."

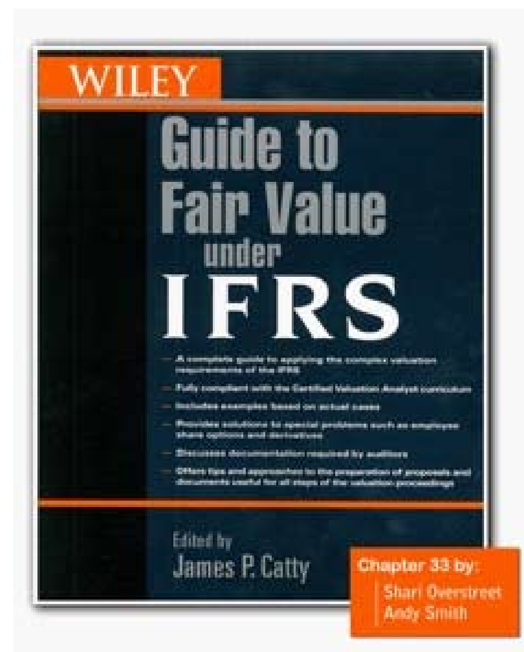
The expert witness applied a 10% discount rate to arrive at the net damages the Plaintiff suffered. The discount rate selected was based on the debtor's actual cost of capital which was 8% with a risk premium of 2%. The expert stated that the discount rate was consistent with the effective annuity nature of the income stream under the CMA, given the fixed price and costs. However, the court decided to raise the discount rate to 15% due to the "normal attendant risks of mining coal". Further adjustments were made to the initial net damages to include the risk of the industry and surface operations that the company faced. The revised net damages of the plaintiff totaled $3.96 million. The outcome of this case reflects the importance of selecting a discount rate that captures not only economic risk, but also specific company and industry risk.

Practice Highlights

Shari Overstreet and Andy Smith co-authored a chapter entitled "Share-Based Payments" in the recently published, "Guide to Fair Value under IFRS."

The chapter offers a comprehensive view on the complex valuation of shared-based payments and their treatment under International Financial Reporting Standards.

This book offers the most up-to-date manuscript that analyzes the various international fair value accounting issues that affect more and more companies that are transitioning to IFRS.



The McLean Valuation Services Group Offices

The McLean Group is a national middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services in more than 30 offices in the U.S. and Canada. Its affiliate, The McLean Valuation Services Group performs business valuation services for transaction, financial reporting, and tax purposes. The McLean Valuation Services Group has dedicated business valuation offices in the following locations:

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