

Valuation Vantage[®]

Insights and Perspectives on Leading Corporate Finance Valuation Issues[®]

Summer 2011

Inside This Issue

- Estimating Value from a Recent Round of Financing
- Changes to SBA 8(a) Rules Require Business Valuations
- Spotlight on Court Cases
- Practice Highlights

Estimating Value from a Recent Round of Financing - Challenges in Applying the Backsolve Method

Analyzing recent transactions in a company's equity can establish a strong indication of value. Such transactions may qualify as Level I or Level II valuation inputs under ASC 802, Fair Value Measurements (formerly SFAS 157). In addition, analyzing precedent stock transactions also is consistent with Revenue Ruling 59-60 that states: "sales of stock of a closely-held corporation should be carefully investigated to determine whether they represent transactions at arm's length."

The backsolve method is a valuation technique that estimates a business' value based on a recent round of financing. The backsolve method typically uses an option pricing model (OPM) to derive the implied enterprise value from the investment's financial terms.

Continued on p.2

Changes to SBA 8(a) Rules Require Business Valuations

Companies participating in the 8(a) program are expected to be significantly impacted by SBA requirement changes that took effect on March 14, 2011. New guidelines and requirements for 8(a) eligibility and continuing eligibility may cause some small businesses to exit the 8(a) program before they fully mature. SBA test requirements – for both initial and continuing eligibility – have been tightened to include the fair market value of all assets in addition to previous requirements related to income and net worth.

Key changes in the 8(a) program are detailed below:

- **Income Levels** - For initial eligibility, the average income level may not exceed \$250,000 annually based on the prior three years, including bonuses and company stock value in lieu of cash. For eligibility continuation, the average income level may not exceed \$350,000 per year based on the average income for the prior three years, including bonuses and company stock value in lieu of cash. Raising the income level requirement from \$300,000 to \$350,000 should benefit minority owners by increasing the pool of eligible owners.
- **Fair Market Value of All Assets** - The new rule of initial eligibility and participation is fair market value of all assets. For initial eligibility, the fair market value of all assets held by an individual may not exceed \$4 million. For continued participation, the

Continued on p.2

The McLean Group's Valuation Practice

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

“Estimating Value from...” continued from p. 1

The method’s applicability depends on several factors:

- **Timing** – A valuation analyst must consider how much time has passed between the valuation date and the most recent round of financing, and whether any material changes have occurred during that time period. The current valuation should be reconciled to the value from the latest round of financing.
- **Qualified Arm’s Length Transaction** – If current investors lead the recent investment (an inside round), the transaction may be dismissed as an indication of value. In addition, if new investors did not perform material due diligence procedures, relying on the transaction may be difficult. According to the AICPA practice aid, if the capital raise doesn’t include new investors or if the round is led by a strategic investor with existing investors tagging along at low levels, the backsolve method may not provide a reliable indication of value.
- **Size** – The size of the investment also should be considered. Some minority investments, when small in size, may not be indicative of fair value.
- **Terms** – The backsolve method, which typically is based on an option pricing model, attempts to include the quantitative aspects of the recent round of financing. However, significant qualitative terms are excluded from the model. Unique voting rights or other provisions may significantly affect the transaction’s underlying value.

When possible, it also can be helpful to perform a discounted cash flow analysis to see if the result from the backsolve method is within a range of reasonableness.

Applying the ‘backsolve method’ involves many details. Quantifying the applicable time to an expected liquidity event and measuring volatility can be challenging. In addition, there is no professional guidance about how to treat expected or potential future rounds of financing. Some believe that future funding from outside investors should not be incorporated into the calculation since the company has yet to receive those funds. Others argue that a future round of financing that is expected to be raised should be taken into account. There are also issues in how to take into account options and warrants that may not have vested as of the valuation date. The treatment of discounts for lack of marketability also can be challenging.

Although recent round of financing can be a strong indication of value, carefully analyzing the nature of the transaction is important to determine whether or not the prior round can be used as an indication of value. ♦

“Changes to SBA 8(a)...” continued from p. 1

fair market value of all assets held by an individual may not exceed \$6 million. The fair market value of all assets includes an individual’s personal residence and stock or ownership interest in the 8(a) company. This new criterion may limit the number of companies remaining eligible for the 8(a) program.

Several potential issues and ambiguities arise with the 8(a) eligibility requirement changes. For example, SBA regulations do not define how the fair market value of assets is to be determined. Also, the normalization of rules across all small business requirements may overlook certain industries’ specific size standards. Thus, some otherwise qualified 8(a) companies will be deemed ineligible before they have a chance to fully mature.

Other 8(a) rule changes include:

- **Excessive Withdrawals** – The rule for excessive withdrawals has been changed to exclude owners’ salaries. This change may limit bonuses and incentives for non-owner officers and managers while increasing the withdrawals paid to owners. Excessive withdrawals are limited to: \$250,000 for firms generating revenues up to \$1,000,000; \$300,000 for firms generating revenues of from \$1,000,000 to \$2,000,000, and \$400,000 for firms generating more than \$2 million in revenues.
- **Audit Requirements** – Revised audit requirements for 8(a) companies are as follows:
 - * Firms generating less than \$2 million in annual revenue: An officer of the company must certify a CPA firm’s compilation or financial statements produced in-house.
 - * Firms generating \$2 million to \$10 million in annual revenue: Financial statements must be reviewed by a CPA firm.
 - * Firms generating more than \$10 million in annual revenue: Financial statements must be audited by a CPA firm.
- **Other 8(a) program changes address:**
 - * Subsequent Small Disadvantaged Business Status
 - * 8(a) Contract Reporting
 - * Office of Inspector General Size Determination Requests
 - * Being Called to Active Duty
 - * Prior Approvals by SBA
 - * Joint Ventures and Mentor/Protégé Relationships

These 8(a) requirements changes will have both positive and negative consequences for small businesses. Regardless, it is more important than ever before that small business owners understand their company’s valuation and the details behind the new SBA rules. ♦

Spotlight on Court Cases

S. Muoio & Co., LLC v. Hallmark Entertainment Investments
2011 WL 863007 (Del. Ch.) (March 9, 2011)

The Delaware Chancery court recently confirmed that no single preferred valuation approach can exclusively and definitively be relied on to value a company. The court said, “There are commonly accepted methodologies that a prudent expert should use in coordination with one another to demonstrate the reliability of its valuation.” The outcome of the Hanover Direct case was cited in the Court’s decision on Crown Media Holdings, Inc. (Crown) that reaffirmed the use of multiple valuation approaches to demonstrate the reliability and accuracy of a business valuation.

Crown Media Holdings (owner of the Hallmark Channel), the defendant, was \$1.1 billion in debt and unable to make scheduled debt service payments for several years. After the primary debt holder and controlling shareholder refused to grant further extensions, management pursued a sale of the company. Crown received three offers, which ranged from \$800 million to \$1.0 billion. The company also received a fourth offer for \$500 million, which was significantly lower in value due to 2008’s economic deterioration. Since none of the offers were large enough to pay-off the company’s \$1.1 billion debt, management decided to pursue a recapitalization of the business.

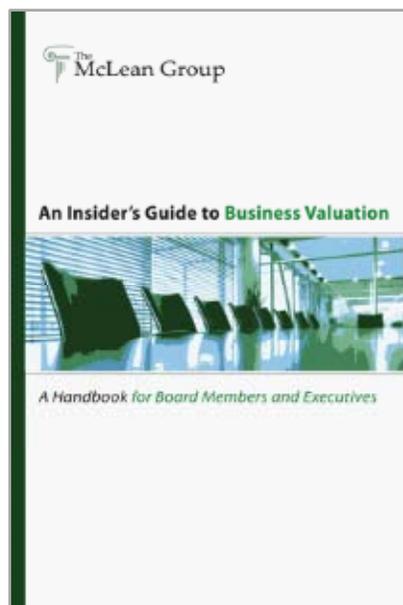
A special committee was formed to evaluate a possible recapitalization of Crown. The committee hired an independent financial advisor who determined Crown was worth between \$500 million to \$1 billion. In addition, a fairness opinion was performed by a separate financial advisor that indicated the minority shareholders of Crown would benefit more from a recapitalization than from a bankruptcy. After Crown’s board of directors approved the special committee’s recommendation, the company recapitalized in June 2010.

One minority shareholder (S. Muoio & Co. LLC), the plaintiff, sued in an effort to rescind the deal, claiming that the process and the price of the recapitalization was unfair and significantly undervalued. Furthermore, the plaintiff claimed that Hallmark management purposefully planned the recapitalization at an unfair time, when the credit markets were frozen and the company had turned the corner on profitability. The plaintiff’s case was based solely on the value from a discounted cash flow (DCF) analysis prepared by S. Muoio & Co.’s expert who valued the company at \$3 billion.

The court rejected both claims by the plaintiff, stating that the special committee was independent and the transaction was negotiated at an arm’s length. In addition, the unfair timing argument was dismissed by the Court because the plaintiff’s claim was based solely on the value from a DCF analysis. Even though the plaintiff’s expert also performed comparable company and transaction analyses, these results were omitted because the valuation figures did not support the DCF analysis. The rejection of other valuation approaches reinforced the Court’s credibility concerns, citing the Hanover Direct decision where the expert failed to explain reliance solely on an outlier DCF value. The Crown and Hanover Direct decisions both demonstrate the importance of independent valuations that are conducted at arm’s length and employ multiple valuation methodologies to derive a reliable and accurate company value. ♦



Practice Highlights



Within the last month, McLean Group partner and head of The McLean Valuation Services Group, Andy Smith, authored *An Insider's Guide to Business Valuation*. The handbook provides board members and executives with a quick reference guide for conducting business valuations for their companies and includes a useful appendix of important questions business owners and fiduciaries should ask when reviewing business valuation reports. Topics covered include: valuation procedures, approaches in valuation, purchase price allocations, impairment testing, allocating equity value, discounts, and fairness opinions, and questions to ask in reviewing a valuation.

Get your copy today! [Click Here](#)



The McLean Valuation Services Group Offices

The McLean Group is a national middle market investment bank providing mergers and acquisitions (M&A), corporate finance, market intelligence and business valuation services with bankers in more than 30 offices in the US. 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:

Washington, DC, Headquarters

Andy Smith, CPA/ABV, ASA, CVA, CMA
7900 Westpark Drive, Suite A320
McLean, VA 22102
703.827.0233
asmith@mcleanllc.com

Austin, TX Office

Shari Overstreet, CPA/ABV, CVA, CM&AA
401 Congress Avenue, Suite 1540
Austin, TX 78701
512.751.7213
soverstreet@mcleanllc.com

Silicon Valley, CA Office

Brian Sullivan, CPA/ABV, CVA, CFE, CBA
177 Bovet Road, Sixth Floor
San Mateo, CA 94402
650.638.2310
bsullivan@mcleanllc.com