The McLean Group
INVESTMENT BANKING

Valuation Vantage©

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Insights and perspectives on leading corporate finance valuation issues.

Inside This Issue

Don't Forget the Fair Value of Operating Leases

As part of the accounting for a purchase price allocation, U.S. GAAP requires several intangible assets to be analyzed, including:

- Customer-based intangible assets
- Marketing-based intangible assets
- Technology-based intangible assets
- Contract-based intangible assets
- Artistic intangible assets

One of the less frequently valued intangible assets is an operating lease, a contract-based intangible asset.

continued

"Don't Forget the Fair Value of Operating Leases" continued

Acquirers must analyze the Fair Value of operating leases if these leases are acquired during an acquisition and if the rent differs from the market at the time of the acquisition, as stated in ASC paragraph 805-20-25-12:

> *Regardless of whether the acquiree is the lessee or the lessor, the acquirer shall determine whether the terms of each of an acquiree's operating leases are favorable or unfavorable compared with the market terms of leases of the same or similar items at the acquisition date. The acquirer shall recognize an intangible asset if the terms of an operating lease are favorable relative to market terms and a liability if the terms are unfavorable relative to market terms.*

When the rent on an operating lease paid by an acquiree is less than the market rate rent, an intangible asset for the operating lease may need to be recorded on the balance sheet. Similarly, if the rent on an operating lease paid by an entity is more than the market rate rent, a liability for the operating lease may also need to be recorded. The following are the main inputs used to determine the Fair Value of an operating lease:

- Rent paid by the target company or acquirer.
- Estimated comparable market rent: For real estate leases, the estimated comparable market rent may be based on commercial real estate brokers' surveys, the National Association of Realtors reports, or other market indices. Of course, the nature of the underlying assets needs to be analyzed.
- Forecast period: The forecast period is based on the remaining period for the property's operating lease.
- Discount rate: Depending on the nature of the lease, the discount rate may be based on applying a long-term growth rate, normally 2-4%, plus the applicable cap rate of the nearest major market for the subject property.

Many times, operating leases can be exempt from a detailed analysis, especially if an operating lease was recently completed or renewed. ◆

Acquirers must analyze the Fair Value of operating leases if the rent differs from the market at the time of the acquisition.

Defendant's Merger Projections Accepted

Merion Capital v. 3M Cogent, Inc., Delaware Chancery Court, Civil Action No. 6247-VCP (July 8, 2013)

In this case, Merion Capital ("Merion" or the "Plaintiff"), a stockholder in 3M Cogent, Inc., formerly Cogent, Inc. ("Cogent" or the "Defendant") dissented and filed a petition for appraisal regarding Cogent's acquisition by 3M for $10.50 per share. The Plaintiff claimed that Cogent's common shares were worth $16.26 per share as of the closing date of the acquisition, not $10.50 per share.

Background

The main disagreement between the Plaintiff and the Defendant regarded the projections used in the discounted cash flow ("DCF") analysis to value Cogent. The Plaintiff's projections were based on industry revenue growth rates that were higher than the Defendant's projected growth rates and clearly had not been met by Cogent in the past.

Also, the Plaintiff's projections included a cash deployment scenario that assumed Cogent would acquire target companies and realize positive returns from these acquisitions, which the Court concluded was too speculative.

In contrast, the projections by the Defendant's CFO were prepared only after 3M gave a verbal offer and were based on significant input from the Defendant's investment bank. Additionally, the Defendant previously did not have projections beyond one year. Although the Court found this factor of the Defendant's projections to be problematic, it found that the Defendant's CFO was not under threat of losing his position after the acquisition of Cogent and therefore was not preparing projections for an alternate bid.[1] As a result, the Court mainly relied on the Defendant's projections.

The Court's Conclusion

The Court concluded a per share value of $10.87 for Cogent based on:

1. The projections prepared by the Defendant's CFO, which were considered close to contemporaneous projections and consistent with the Delaware Chancery Court's preference for management projections.

2. A greater assumption of excess cash compared to the Plaintiff's assumption, albeit with the Plaintiff's speculative cash deployment scenario not used in the DCF.

Best Practices

Cogent management's projections were relied upon for the Court's DCF analysis and the Court highlighted that contemporaneously prepared management projections are more likely to be in accordance with valuation standards. This case reinforces the importance of using management projections, and not including future acquisitions by the subject company. ◆

[1] In the Gearreald case, where directors or officers of a subject company risked losing their positions from the subject company, the Court found that these individuals prepared different projections for different strategic alternatives in order to protect their positions. As a result, the Court found that the projections prepared by management would not be truly reflective of the subject company's projections as of the valuation date.

Estate of Richmond

Estate of Helen P. Richmond v. Commissioner, TC Memo 2014-26 (February 11, 2014)

In this case, the IRS ("IRS" or "Respondent") levied a gross valuation misstatement penalty of 40%, which was appealed by the Estate of Richmond ("Petitioner") to the U.S. Tax Court.

Background

The Petitioner claimed that the fair market value of its interest in a family-owned investment holding company, which was the main subject of the dispute, was $5,046,500 compared to the Respondent's conclusion of $7,330,000. The Petitioner's valuation expert used a capitalization-of-dividends method to value the Petitioner's interest in the holding company. In contrast, the Respondent's valuation expert used a net asset valuation method.

The next point of dispute was the impact of the built-in capital gains tax. The Petitioner argued that the holding company's value should be discounted by 100% of its built-in capital gains. The Respondent argued for none of the holding company's value to be discounted by built-in capital gains when the Respondent sent the Petitioner its notice of deficiency, although this was later revised to 43% by the Respondent's expert.

Regarding discounts for lack of control and lack of marketability, the Petitioner's valuation expert chose 8% and 35.6%, respectively, while the Respondent's valuation expert chose 6% and 21%, respectively.

The Court's Conclusion

The Court found the Respondent's valuation expert's use of the net asset valuation method to be more appropriate since the assets under the holding company were all marketable securities of which its prices could be readily obtained.

On the matter of built-in capital gains, the Court agreed with the Respondent's percentage of the built-in capital gains used to discount the holding company's value, but it disagreed with the Respondent's valuation expert's methodology.

Regarding the discounts for lack of control and lack of marketability, the Court chose 7.75% and 32.1%, respectively, based on the medians of closed-end funds and restricted stock studies. Lastly, the Court upheld the Respondent's gross valuation misstatement penalty of 40%. ◆

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The McLean Group

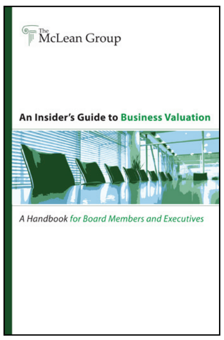
Headquartered in the Washington, DC metropolitan region, The McLean Group provides M&A, business valuation and strategic consulting services to middle market businesses.

Practice Highlights

On April 23 and 24, 2014, The McLean Group held its sixth Annual Conference in McLean, VA. More than 50 bankers and analysts from headquarters and offices across the country were in attendance. The two-day event featured speakers from The Federal Reserve, Goldman Sachs, BNY Mellon, Milestone Communications, Lee Lowinger PC, PNC and Hinge Marketing.

CFA Institute

On June 17, 2014, The McLean Valuation Services Group Principal, Andy Smith will be participating on a panel, "Issues With Private Equity Valuation - Top Performance or Inflated Valuations?" in association with the CFA Society of Washington, DC. Other panelists include Duff & Phelps' Jouky Chang and Rothstein Kass' Michelle Keyes. Register **here.**



The McLean Valuation Services Group's Andy Smith has published *An Insider's Guide to Business Valuation: A Handbook for Board Members and Executives.* The handbook provides an overview of various issues many business owners and fiduciaries encounter when having a business valuation performed. The handbook includes a useful appendix of important questions board members and executives should ask when reviewing business valuation reports. Copies of the book may be purchased **here.**

The McLean Valuation Services Group

As a core competency and complement to our 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. The McLean Valuation Services Group has the requisite experience and credentials to support litigation proceedings, including quantifying economic damages and valuing business interests.