The McLean Group
INVESTMENT BANKING

Valuation Vantage©

Fall-Winter 2012

Insights and perspectives on leading corporate finance valuation issues.

Inside This Issue

New Guidance on When to Use A Recent Round of Financing to Estimate Fair Value

On August 10, 2012, the American Institute of CPAs' ("AICPA") task force released its working draft of the Accounting Valuation Guide. In Chapter 8 of this release, titled "Inferring Value from Transactions in a Private Company's Securities," the AICPA provided guidance for evaluating private transactions with regards to their relevance in estimating the Fair Value of other securities within an enterprise via the back-solve method. As background, the back- solve method uses the terms of a private transaction and a company's capital structure to calculate the implied Fair Value of a company and its other securities.

continued

"New Guidance on When to Use A Recent Round of Financing..." continued

The taskforce identified three types of private preferred stock transactions that may be completed, each with varying degrees of relevance as an indication of Fair Value: simple, strategic and tranched preferred financing.

Ideally, a simple preferred stock financing transaction is conducted at arm's length, includes new investors, and involves a company that is not in distress. A simple transaction may also reflect Fair Value if it involves pre-existing investors so long as the company is not in distress and negotiations remain robust. Typically, up or down financing rounds – as opposed to flat financing rounds – are indicative of thorough due diligence and consequently representative of Fair Value. However, when a company is in distress, the price of a new round may not reflect a going concern or may reflect some degree of a lack of marketability. To remedy lack-of-marketability issues, the transaction price might be adjusted to reflect a slight premium for the recent round.

As the name implies, a strategic preferred stock transaction involves a strategic relationship in which the investor and/or the company will benefit from the relationship in a way that does not necessarily directly benefit the other party. Consequently, the transaction price may not reflect a price that a hypothetical market participant would pay and thus is not indicative of Fair Value. In such cases, creating a model to value the equity using other methods and then reconciling the model's values to the transaction price might ensure that the price paid falls within a range of reasonableness despite the strategic benefits realized by the investor/company. If the transaction price is at market despite strategic benefits to either party, the back-solve method may be appropriate without requiring additional adjustments.

A tranched preferred investment is a transaction in which an investor agrees to buy a certain number of shares at an initial closing date, and additional shares at one or more future dates, at a pre-negotiated price regardless of whether the company's value has changed for other reasons. Typically, the future investments are contingent upon the company reaching certain milestones and the two parties usually are committed to completing the subsequent tranches when the milestones are met. The tranched structure creates a contingent forward contract, rather than an option. Thus, if the price is pre-negotiated and the company's value has changed as the milestones are reached, the purchase price is not indicative of Fair Value. To remedy this, tranched preferred financing transactions must be segmented between the initial investment and forward contracts, and valued separately.

To represent Fair Value, a transaction must be thoroughly vetted and at arm's length whether or not the relationship is strategic and whether the investor is new or pre-existing. Applying the back-solve method to preferred stock transactions can be an effective means of calculating the Fair Value of a company so long as the aforementioned criteria is met, and more importantly, reasonable judgment is applied. ◆

Step 0 Impairment Testing for Goodwill and Other Intangible Assets

In accordance with the guidance provided by the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 350 – Goodwill and Other, companies should test their goodwill and indefinite-lived intangible assets for impairment at least annually. In 2011, the FASB issued new guidance allowing goodwill to be tested based on a qualitative assessment. The intent of the FASB's recently-issued guidance was to simplify and reduce costs associated with performing annual goodwill impairment tests.

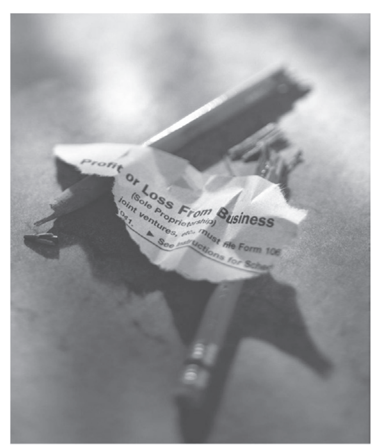
The basis of this qualitative assessment – which is called "Step 0" analysis – is to determine whether it is more likely than not (i.e. a greater than 50% chance) that a company's goodwill is valued at less than its carrying amount. When a company passes the Step 0 analysis, it is assumed that its goodwill is not impaired and no further testing is required.

However, when a company does not pass the Step 0 analysis, the quantitative goodwill impairment test must be performed. Because Step 0 analyses are not required, companies may proceed directly to Step 1 of the goodwill impairment test, if desired.

The FASB's June 2011 guidance was intended specifically for goodwill and did not impact the guidance on testing indefinite-lived intangible assets. However, in July 2012, the FASB also issued new guidance for impairment testing of indefinite-lived intangible assets (i.e. intangible assets not subject to amortization) in accordance with ASC 350. Similar to the Step 0 for goodwill impairment testing, companies at their option may perform qualitative assessments to determine whether it is "more likely than not" that their indefinite-lived intangible assets are valued at less than their carrying amounts.

Since Step 0 analysis for indefinite-lived intangible asset testing is not required, companies may proceed directly to performing a quantitative test of the indefinite-lived intangible assets.

Given the FASB's recent modifications to both goodwill and indefinite-lived intangible asset testing, management should monitor the qualitative aspects of the business that may impact the value of the reporting unit and/or indefinite-lived intangible asset(s) throughout the year, making it less burdensome to provide qualitative proof demonstrating the "more likely than not" possibility of no impairment.



continued

"Step 0 Impairment Testing..." continued

Factors to consider when assessing goodwill impairment or indefinite-lived intangible assets include:

- Cost factors: increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows

- Macroeconomic conditions: deteriorating general economic conditions, limitations on assessing capital, fluctuations in foreign exchange rates, or unfavorable developments in equity and credit markets

- Industry and market conditions: deterioration in the environment in which an entity operates, increased competition, declining market-dependent multiples or metrics, changing market conditions for an entity's products or services, or negative regulatory or political developments

- Overall financial performance: negative or declining cash flows, declining actual or planned revenues or earnings vs. actual or projected results

- Other relevant entity-specific events: changes in management, key personnel, strategy or customers; threats of bankruptcy or litigation, and

- Events affecting a reporting unit (for goodwill impairment testing only): changes in the composition or carrying amount of net assets, more-likely-than-not expectations of sale or disposal of all, or a portion, of a reporting unit, testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in financial statements of a subsidiary that is a component of a reporting unit.

Because the above factors do not constitute an exhaustive list, management should consider and thoroughly document all relevant facts and circumstances related to fair value of a company's reporting unit and/or fair value of its indefinite-lived intangible assets.

In conclusion, the Step 0 analyses for goodwill and indefinite-lived intangible assets may provide favorable impairment testing solution if underlying qualitative factors provide reasonable support to a company's auditors. However, the Step 0 analysis may also prove to be less favorable for companies that are obligated to proceed to quantitative tests based on the conclusions from the qualitative assessment. When management is uncertain whether or not its company or reporting unit would pass a goodwill impairment test or indefinite-lived impairment test, it may be prudent and more cost effective, to forego Step 0 qualitative assessment and proceed directly to a quantitative test. ◆

More Pressure on Impairment Testing Valuations, Particularly if the CEO Sells Stock

Brasher v. Broadwind Energy, Inc.

2012 U.S. Dist. App. LEXIS 55194. (April 19, 2012)

As 2012 draws to a close, many clients are requesting goodwill impairment tests which are important – and required – for any company having goodwill on its balance sheet. Impairments may have particularly detrimental and even irreversible effects on companies whose stock could take a hit as soon as news of a write-off became public.

The Case

Broadwind Energy acquired a subsidiary in 2007 and booked intangible assets of $105 million, primarily in goodwill and a customer-related intangible asset for its two largest customers. By 2008, one customer wanted to renegotiate its contract while the other simply stopped paying.

In the wake of these developments, the Broadwind Energy subsidiary was forced to lay off half its workforce and was rendered unable to meet its financing obligations. It proposed to raise additional capital through a public offering. In January 2010, the subsidiary sold 15 million shares of common at $5.75 per share to raise approximately $54 million. The subsidiary then revealed that approximately half of the 15 million shares had been sold by Broadwind's CEO and a private equity fund with a controlling stake in the subsidiary.

Two months after the 15 million share public offering, the subsidiary reported Q4 2009 revenues of $33 million and a $93 million net loss.

The valuation firm engaged to perform the company's annual goodwill impairment test calculated an $82 million impairment charge to goodwill and customer-related intangible assets which represented a write-down of approximately 63% of Broadwind's goodwill and intangible assets.

Broadwind's share price fell 20% upon release of the news and declined another 50% by August 2010. Plaintiffs subsequently brought a class action suit against the company, the private equity firm, and various executives on behalf of anyone who had purchased Broadwind stock between March 2009 and August 2010. The plaintiffs also charged that the CEO "absolutely knew" prior to the January 2010 offering that a substantial write-down of goodwill would follow.

continued

"More Pressure on Impairment Testing Valuations…" continued

Based on the facts presented, the court concluded it was "difficult to imagine" that the defendants did not know by January 2010 that a substantial write-down was a "certainty" even though they failed to make any disclosures until nearly two months later, in March 2010. Furthermore, having allocated a significant share of the subsidiary's 2007 purchase value to its two largest customers, the defendants watched those same two contracts decline significantly following the 2007 acquisition and knew a material change in their value was inevitable.

Court Decision

"Broadwind could not mislead investors as to what it knew the tests would reveal. There are very few entirely 'objective facts' in the world of intangible asset valuation; that Broadwind was going to take a substantial hit when impairment testing was complete…is about as close as it gets," the court held.

In response to the defendants' claims that retaining an outside appraisal firm to conduct the impairment test should protect them, the court concluded, "No one is claiming that the results of the testing were inaccurate; the claim is that the testing should have been done much sooner. The appraisal firm plays no role in determining when to test assets; they simply review how they are tested." ◆

McLean Valuation Services Group Team

Dennis Roberts
Chairman
McLean, VA
droberts@mcleanllc.com
703.827.0008

Andy Smith
Principal
McLean, VA
asmith@mcleanllc.com
703.827.0233

Ryan Berry
Principal
McLean, VA
rberry@mcleanllc.com
703.827.0091

Shari Overstreet
Managing Director
Austin, TX
soverstreet@mcleanllc.com
512.751.7213

Brian Sullivan
Managing Director
Silicon Valley, CA
bsullivan@mcleanllc.com
650.638.2310

The McLean Group

The McLean Group is an investment bank providing M&A, business valuation and strategic consulting services to middle market businesses. Headquartered in Washington, DC, we are among the largest independent middle market investment banks in the nation with a broad resume of successfully consummated financial transactions.

Practice Highlights

ACQUISITION INTERNATIONAL M&A Award Winner 2012

The McLean Group was awarded the USA Middle Market Investment Bank of the Year Award by *Acquisition International. Acquisition International*, a UK-based global corporate finance news magazine, recognized leading dealmakers like The McLean Group in its summer awards supplement. In partnership with Preqin (Sponsor) and DealGate (Media Partner), this marks the culmination of *Acquisition International*'s six month search for the very best M&A teams worldwide—those that have shown the greatest strength amid on-going global economic uncertainty. Read the press release here.

ACG® Central Texas

In November, the Austin Office's Managing Director Shari Overstreet participated in a highly attended panel discussion about valuation issues to consider when planning an exit at The AT&T Conference Center in Austin, TX. The panel addressed such topics as: when to begin planning, how to assemble a team, recap options, timing your exit, key pitfalls to avoid that can cause a deal to fall apart, and much more.

This October, Andy Smith, Principal of The McLean Group and The McLean Valuation Services Group, moderated Northern Virginia Technology Council's CFO Series event, "What Is My Value? - Deciphering the Valuation Issues that CFOs Face" at The Ritz Carlton in Tysons Corner, VA. Panelists included representatives from Ernst & Young, Alvarez & Marsal and The Carlyle Group.

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.