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Putting a price tag on synergy

When does one plus one equal three? In successful business combinations, the value of the combined entity often exceeds the sum of the parts operating independently. This incremental value commonly is referred to as “synergy.”

Types of business combinations

When prospective buyers contemplate a merger or acquisition, they may choose among several types of target combinations, including:

Horizontal. In this case, competitors or other industry participants operate in different markets.

Vertical. This involves companies at different stages in the prospective buyer’s supply chain, such as suppliers, brokers or customers.

Congeneric. In this type, combining businesses serve substantially different markets but share another important operating characteristic, such as a common customer base or similar distribution channels.

Conglomerations. Here, the combining entities are completely unrelated but the proposed combination offers the companies an opportunity to diversify into new markets.

One key reason
for failed business
combinations:
overvalued synergy.

To maximize proceeds, most sellers prefer horizontal or vertical combinations. With these types, sellers are likely to generate higher potential synergies — through cost savings and revenue growth opportunities — than with congeneric transactions or conglomerations.

Sources of synergy

Most synergies stem from the potential for enhanced operating efficiencies. Combined entities often achieve



economies of scale by sharing fixed costs. A newly combined entity may, for example, require only one accounting department and may be able to share a marketing program.

Some buyers and sellers leverage each other’s competitive strengths. For instance, suppose Company A possesses a state-of-the-art inventory management system and an exceptional sales force. Company B offers top-notch customer service and strong brand identity. Combining the two entities creates a powerhouse with the best attributes of both standalone businesses.

Alternatively, an acquisition target may be inefficiently managed. After closing, the purchaser plans to “clean house” with its own professional management team. Similarly, a larger combined entity may have sufficient clout to negotiate better prices and terms with its suppliers.

Still other synergies result from revenue-building opportunities. For example, larger entities may offer complementary products, resulting in more efficient, less costly advertising efforts. Some acquisition targets may have previously forgone growth opportunities due to insufficient cash flow or limited access to capital markets. By combining with a larger company, the target is free to expand.

Some operating synergies may require plant closings or employee layoffs, which can cause inadvertent postdeal assimilation and productivity issues.

Fair market value

The typical standard of value in business appraisals, fair market value, is a logical starting point for valuing synergy.

Treasury department regulations define fair market value as:

The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

In other words, fair market value is the price for which the universe of buyers and sellers agree to exchange a business interest. But few businesses sell for fair market value. Instead, sellers hold out for strategic buyers, who often are willing to pay a premium for control attributes and synergy. So, absent liquidation, compulsion or misinformed market participants, fair market value often represents the floor for M&A negotiations.

Strategic vs. synergy value

Strategic value — that unique to one specific investor — is the preferred standard in business combinations. Also called investment value, strategic value considers a specific investor's unique expectations, risks, tax situation and synergies.

When quantifying strategic value, appraisers frequently focus on the discounted cash flow method over other valuation techniques. Key inputs include management's projected cash flows, expected growth rates and the combined entity's expected cost of capital.

Put simply, synergy value is the difference between 1) the sum of the companies' fair market values without pursuing the business combination, and 2) the strategic value of the combined entity. In most cases, buyers aren't willing to offer a premium equal to the full value of synergy, especially if synergy results from the buyer's resources or managerial expertise. So, synergistic value (fair market value plus the value of synergy) often represents the ceiling for M&A negotiations.

THE RIGHT PERSON FOR THE JOB

A business appraiser may seem like the logical go-to person for valuing synergy. But before hiring a financial expert to handle your merger or acquisition, ask a few questions. Getting answers to these questions can go a long way toward ensuring you find the best appraiser for the job.

How much M&A experience does the appraiser possess? The standard of valuation in business combinations (strategic value) differs from traditional valuation assignments (typically fair market value).

Does the valuator have strong verbal communication skills?

The appraiser's role in M&A extends beyond written reports. Often valuers accompany clients to negotiation talks and are expected to communicate valuation issues clearly.

Is the appraiser familiar with the industries of both the buyer and seller? To evaluate the reasonableness of management's financial projections, an appraiser must possess an in-depth understanding of how an industry operates, including industry-specific jargon, accounting nuances, trends and forecasts.

Does the appraiser have adequate resources on hand to address imminent M&A issues? In business combinations, time is of the essence. Hasty or incomplete due diligence can lead to misinformed decision making. Conversely, prolonged deliberations can result in missed opportunities.

Accordingly, the actual transaction price typically falls somewhere between the target company's fair market value and its synergistic value. In essence, the level of synergistic value centers on the buyer's perceived benefits from the proposed acquisition. If the asking price exceeds synergistic value, prospective buyers should be prepared to walk away from the negotiating table.

The synergy trap

Quantifying synergy is no easy task. It requires complex, subjective financial analysis. In fact, many mergers and acquisitions — even those involving large public companies with sizable resources at their disposal — fail to create value for the acquirer's shareholders.

One key reason for failed business combinations: overvalued synergy. Management's previous budgeting track record, past M&A experience, and familiarity with the target's market and industry

(if different from the acquirer's business) can affect the reliability of management's forecasts for the combined entity.

In these cases appraisers often play devil's advocate, questioning whether management considered factors that might diminish potential synergies. For example, does management allow for a reasonable assimilation period before synergies begin to affect projected cash flows? Does management consider postdeal assimilation costs — such as incongruent corporate cultures or incompatible information technology systems — that offset potential synergies?

Sanity checks

A value conclusion is only as reliable as the underlying assumptions. Valuers can help the parties evaluate whether their expectations appear reasonable. When management's financial projections appear incomplete or unrealistic, valuers may substitute their own analyses. A sanity check may modify specific management projections or calculate value using an alternative approach (for example, the market or asset approach). The goal, of course, is to arrive at a reasonable and supportable value conclusion in light of all the surrounding facts and circumstances. ■

Cash is king when evaluating financial performance

Many lenders, investors and accountants have developed a myopic approach to evaluating business performance that focuses predominantly on profits. But experienced business owners know that profits mean nothing if there isn't enough cash left over to pay their salaries and dividends. At the end of the day, cash is king.

Valuation experts have more in their bag of tricks than the ability to appraise a business interest. As part of their professional training, valuers learn how to project cash flows and to calculate the present value of those cash flows using an appropriate discount rate. This expertise makes them uniquely suited to help management prepare cash flow budgets; evaluate strategic investment decisions; devise reorganization strategies; and brainstorm profit and efficiency enhancement alternatives.

Cash flow vs. net income

Net income is an artificial accounting concept. It may include noncash expenses, such as depreciation and amortization, as well as obscure charges for, say, asset impairment or changes in accounting methods. But

unlike cash flow, it fails to consider routine expenditures, such as equipment purchases, incremental working capital needs, debt service and dividend payments, which eat at cash reserves.



A common question from frustrated business owners is: Why does my profitable business frequently seem on the brink of a cash crisis? Although normally desirable, growth is often the culprit. Mastery of several key managerial concepts can help business owners manage cash flow more efficiently and survive the monthly (or off-season) cash crunch.

Cash operating cycles

The cash operating cycle is the amount of time it takes a business to convert raw materials into cash collections. The clock starts ticking as soon as inventory is purchased, continues running during the manufacturing and billing processes, and stops when the customer pays the invoice.

Unfortunately, most businesses receive payment from customers long after they've paid for key operating costs, including salaries, rent and supplies. The lag

between cash receipts and cash expenditures can cause a cash shortage, if not properly planned for. Higher growth rates and longer cash operating cycles compound cash shortfalls.

Fundable growth rates

A common question is: How much growth can current business operations sustain without seeking additional debt or equity financing? One way to approach this question is to consider the fundable growth rate (FGR). The FGR represents the growth rate at which cash inflows (for example, from profits and reserves) equal cash outflows (say, for incremental working capital requirements, debt service and dividends). Any growth rate above the FGR creates a cash deficit, because the company is using cash faster than it can bring money in the door. On the other hand, slower growth generates positive cash flow and builds reserves.

“Fundable growth rate: A simplified example” below shows how FGR works. In this case, a company with \$5 million in annual revenues can afford

to grow at a maximum rate of 41.9% without additional financing.

This example is limited by its underlying assumptions, however. For example, the model assumes:

- All expenses are variable,
- Working capital increases in direct proportion to revenues,
- Depreciation expense (net of its tax benefits) reasonably approximates the need for capital expenditures, and
- No dividend payments exist.

Moreover, because it shows only year-end numbers, the example fails to capture interim cash flow problems. This example is for illustrative purposes only — FGR calculations can be customized to include greater detail, more time periods and additional assumptions.

Options for surviving the cash crunch

Few managers opt to forgo growth. So, realistically, the key to managing cash flow lies in shortening the cash operating cycle. Business owners have various solutions to the cash crunch. They can:

- Increase price per unit,
- Reduce accounts receivable by tightening credit approval policies or offering early-bird discounts,
- Lower inventory by conducting a contribution analysis or writing off obsolete items,
- Stretch payments on accounts payable,
- Cut operating expenses, or
- Minimize taxes through effective tax planning.

Owners can revise their FGR analyses to determine which solutions — or combinations of solutions — have the biggest impact on cash.

Speaking the universal language

Unlike accountants — who tend to communicate in terms of balance sheets and income statements — valuers appreciate the role that cash flow plays in driving shareholder value. They can help explain complex business concepts in terms of their effects on cash. For those down in the trenches, that’s a refreshing change of pace. ■

FUNDABLE GROWTH RATE: A SIMPLIFIED EXAMPLE*

	Year 1	Year 2	Growth
Revenues	5,000	7,095	41.9%
Net profit %	5.5%	5.5%	
Net income	275	390	41.9%
Working capital	1,050	1,490	41.9%

Cash available from operations

Cash reserves	100
Net income	390
Total cash available from operations	490

Cash requirements

Increase in working capital	440
Debt service	50
Total cash requirements	490

Cash surplus (deficit)	0
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* All numbers are in thousands and rounded to the nearest whole number.

Trade secrets: An economic damages case

A recent circuit court case, *Carbo Ceramics Inc. v. Keefe*, provides a framework for developing economic damage theories in trade secret misappropriation cases. The case suggests the reasonable royalty method is the preferred approach when trade secret misappropriation is imminent but no actual damages have occurred.

Some background

After terminating his employment with Carbo Ceramics Inc. in May 2001, Terry Keefe planned to open his own proppant (an industrial lubricant) manufacturing plant. Although his plant was not yet operational, Keefe projected the new venture would generate roughly \$238.5 million in revenues over a ten-year period.

Carbo alleged that Keefe breached his fiduciary duty as an officer of the company and his confidentiality agreement with Standard Oil (Carbo's predecessor-in-interest). Carbo also charged Keefe with misappropriating trade secrets, including information related to Carbo's proppant manufacturing process, business plans and pricing strategies.

Valuation-related issues

Carbo, the plaintiff, had the burden to prove lost profits. Accordingly, it hired a valuation expert to estimate the value of its manufacturing trade secrets to Keefe (rather than to Carbo).

The appraiser used the “profit-split method.” This method involves splitting a portion of the gross profit between the company using the trade secrets (Keefe) and the company owning the trade secrets (Carbo). Based on Keefe's own financial projections, the valuator estimated lost profits from trade secret misappropriation at \$3.9 million.

The court's findings

Carbo appealed a summary judgment issued by the district court that denied it any economic damages for misappropriated trade secrets or breach of confidentiality. Based on relevant case law, the Fifth Circuit outlined four theories for estimating lost profits:

1. To what extent did the defendant actually profit from the use or disclosure of the trade secret?
2. How much would a reasonably prudent investor pay for the use of the trade secret?
3. How much did the defendant save — typically in terms of developmental costs — by misappropriating trade secrets?
4. What price would a willing buyer and seller negotiate for “reasonable royalties” for use of the trade secret?

In cases such as *Carbo*, where the trade secret has not actually been destroyed and the plaintiff is unable to prove specific injury, legal precedent suggests that the reasonable royalty method is the appropriate measure of damages. When quantifying royalties, courts consider resulting and foreseeable changes in the parties' competitive posture, prices paid by licensees in the past, the total value of secrets to the plaintiff (including the plaintiff's development costs and the importance of the secret to the plaintiff's overall business), the nature and extent of the defendant's intended use of the secret, and other case-specific factors affected by the parties' agreement.

The plaintiff's expert didn't use any of the damage theories the court outlined. Moreover, Carbo's



“split-profit” damage theory was based on speculative revenues and operating profit from an unbuilt plant. With no evidence of recoverable actual damages, the Fifth Circuit affirmed the district court’s decision to deny Carbo economic damages under its trade secret misappropriation and breach of confidentiality claims. Furthermore, the court remanded the issue of permanent injunction to the lower court for reconsideration.

Lessons learned

Carbo underscores the importance of collaboration between attorneys and valuers to ensure experts choose the appropriate methodology based on relevant case law. When an expert’s analysis contradicts legal precedent, it can mean the difference between winning and losing the case. ■

Valuation reports

It’s not just what you say but also how you say it

Business valuations involve numerous complex analyses that can be difficult to explain to laypeople. To ensure the message gets across to its intended audience, a valuator needs to select the appropriate reporting format — which depends, among other things, on the valuation’s purpose and the client’s needs.

Tell it like it is

For strategic purposes, in some circumstances valuers prefer verbal explanations. An oral report may be appropriate for an engagement that involves consulting services. In addition, timing or fee issues may prompt an oral report. For instance, a board of directors contemplating a merger or acquisition might request an expedient oral presentation of the expert’s analysis — especially in a seller’s market.

Conversely, a company on the verge of bankruptcy may lack discretionary cash flow to pay for a comprehensive written report. An oral summary of potential liquidation and restructuring alternatives may better serve the client’s needs.

Get it in writing

But in most cases, valuers choose to convey their opinions with a written report. Tangible reports enable business owners and attorneys to review the valuator’s analyses, ask questions and assess whether conclusions appear reasonable.

In litigation, written reports facilitate settlement, because experts can compare their analyses and pinpoint key financial differences. Whether the reporting medium is oral or written, the analyses and procedures underlying a formal business valuation are the same. Although it may seem less formal, the use of oral reports doesn’t permit a valuator to sidestep financial principles or professional standards.

Limited scope

Sometimes a controlling shareholder refuses to permit the opposing side’s valuator to conduct a site visit or to interview management. Or a client may request that the valuator perform one specific step of the valuation process — such as a compilation of guideline private transactions — and omit other valuation techniques.

If a valuator can’t perform all routine valuation procedures, he or she issues a limited valuation report. In any event, the valuation expert must communicate a full understanding of the scope of the engagement (including any limitations) to the client and any other users of the report.

Finding a happy medium

The appropriate medium for communicating value is an important decision that depends not only on the valuation’s purpose but also on the preferences and sophistication of the intended audience. ■

Business Valuation Group

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- Ownership Disputes
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- Succession Planning
- Employee Owned Business (ESOP)
- Sale of Business or Division

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