

A vertical decorative image on the left side of the slide. It features a collage of financial-related elements: a line graph with an upward trend, a pen resting on a document, and various text labels such as 'S&P 500', 'DOW JONES', and 'RUS'. The overall aesthetic is professional and business-oriented.

The Market Participant Acquisition Premium

Travis W. Harms, CFA, CPA/ABV

Mercer Capital

harmst@mercercapital.com | 901.685.2120

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Disclaimer

- + The views expressed do not necessarily represent the views, positions, or opinions of any organization referenced in the material or Mercer Capital
- + These materials, and the oral presentation accompanying them, are for educational purposes only
- + Special thanks to other members of the Appraisal Foundation's working group for allowing me to recycle many of their slides





Today's Presentation



Background

Why does it matter?

Overview of WG3 Efforts

What are we doing?

Example

How can we help?

Q&A / Discussion

What do you think?



BACKGROUND

Why Does It Matter?





Why the Focus on Control Premiums?



SEC focus

Equity market volatility

Diversity of practice



A Sample of SEC Comments

...we have read your response to comment in our letter dated June 30, 2009. In future filings, please ensure you disclose the basis for why a control premium of between 35% and 40% of market capitalization is reasonable...

...If you included a control premium in a goodwill impairment evaluation utilizing the quoted market price of your common shares, please tell us how you determined that control premium and why you believe the assumed premium is appropriate in your circumstances.



December 2008 Speech by Robert Fox (SEC)

...the amount of a control premium in excess of a registrant's market capitalization can require a great deal of judgment. Contrary to some rumors I have heard, the staff does not have "bright line" tests...

...an important factor to consider is their recent trends in market capitalization...in volatile markets, and other unique circumstances, it may not always be reasonable to look at a single day's market capitalization...

...[a control premium] based on an arbitrary percentage determined by a "rule-of-thumb" would not appear to be well reasoned...



Equity Market Volatility



Diversity of Practice

Consensus within the profession has been elusive

- Eric Nath – BVR 1990
- Michael Bolotsky – BVR 1991
- M. Mark Lee – BVU 2001
- Aswath Damodaran – 2005



OVERVIEW OF WG3 EFFORTS

What Are We Doing?

Efforts that Address Control Premiums

Appraisal Foundation Third Working Group

- For business valuation – primarily impairment
- Step transactions
- Investment company issues

AICPA – Impairment Task Force

- Focus on premiums as it relates to testing for impairment of reporting units

AICPA – Valuation of Privately Held Company Equity Securities Issued as Compensation

AICPA – Portfolio Valuation Task Force





Considerations

Different standards of value exist for different valuation purposes

Depends on both the unit of account and the inputs used in the valuation

Refer to the appropriate standards which specify the unit of account for each asset or liability when thinking about control premiums





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**Two discussion drafts have been released;
final exposure draft due to be released soon**

**Focuses on the concept of control premiums,
when measuring fair value for financial
reporting purposes. It does not address:**

- Premiums in other contexts such as tax or disputes
- Discounts for lack of control

Focus on control premiums when considering:

- Impairment
- Investment company holdings
- Step transactions

**Once finalized it is expected to be accepted by
audit firms as “best practice”**



Appraisal Foundation Third Working Group

Core Message: Ontology Matters.





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A control premium describes the relationship between two values – it defines neither





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What is a control premium?

- A fairly controversial concept
- Some would argue that it doesn't really exist or is rare

Some of the prerogatives of control include:

- The ability to make all management decisions
- The ability to benefit from synergies available through combinations with other entities
- The ability to change the cost of capital to the entity by changing the capital structure
- Reducing the cost of capital due to achieving greater diversification and size



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**The monograph introduces the term
Market Participant Acquisition Premium
(MPAP)**

**Differentiates those elements of value
above marketable non-controlling share
value that are appropriately included in
the Fair Value of a controlling interest for
financial reporting**



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The MPAP Definition:

- The premium that describes the price paid by a set of market participants in order to acquire a controlling interest
- It is also the difference between (i) the price that would be paid by those market participants for the subject controlling interest (fair value) and (ii) the value of marketable non-controlling interests in the subject business (“Foundation Value”)
- Represents the enhancement to value that market participants would expect to realize (and pay for) as a result of enhanced cash flows and/or reduced risk if they gain control over the subject business



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Fundamental perspective of the group:

- Prices paid for control of entities can reasonably reflect the economic benefits the buyers expect from ownership of the entity





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Fundamental perspective of the group:

- Quantification of economic benefits typically focuses on:
 - + Cash flow impacts
 - Enhanced growth,
 - Increased margins,
 - Working capital and capital expenditure efficiencies
 - + Reduced Risk
 - Greater size and diversification of the post-acquisition company
 - Buyer has better access to less costly capital
 - Optimizing the financing mix of a company

Excursus: Measuring the MPAP

The Working Group believes that measuring the MPAP on an enterprise basis is more consistent with the underlying factors influencing the premium

	<u>Marketable Non-controlling</u>	<u>Fair Value</u>
Enterprise Value	\$4,715	\$6,354
Interest-Bearing Debt	1,716	1,716
Equity Value	\$2,999	\$4,638
Shares Outstanding	300.0	300.0
Fair Value per Share	\$10.00	\$15.46
MPAP (Equity)		54.6%
MPAP (Enterprise Value)		34.7%





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Fundamental perspectives of the group

- The market participant, a rational buyer, will pay no more than necessary to outbid the next most aggressive bidder for a given investment opportunity
- Bidder interest matters: where bidder interest is low, the market price is less likely to reflect significant MPAP benefit, but where there is robust bidder interest, the price may reflect a higher portion of the available benefits of the MPAP
- In no case is a market participant willing to pay an amount that exceeds the value of the maximum cash flows that can be generated through the business combination
- In addition, control is often expressed on a spectrum and can also be applicable when an entity has significant influence over another entity



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Fundamental perspective of the group:

- An entity might have a greater value after an acquisition than it has under current management
- The Working Group also believes that premiums for control may not always be warranted
- If current management is already operating in a manner that is similar to the value that would reasonably be achieved after an acquisition, then the value before and after acquisition would reasonably be similar



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Fundamental perspective of the group:

- The level of analysis should reflect the importance of the premium to the analysis
- A benchmark control premium resulting from the analysis of comparable transactions typically is a basic approach to understanding value
- Detailed analysis of the enhanced cash flows attributable to control provides the best form of support for control premiums



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Examples of items to consider when studying MPAP:

- Who are the market participants (strategic, financial, etc.)
- Size of market participants vis-à-vis target
- Stage in life cycle of subject entity
- State of industry acquisition activity
- Growth rate of peer companies
- Margins of peer companies
- Balance of information
- Capital structure of the target company
- Perceived quality of management
- Contingent consideration
- Regulatory factors


EXAMPLE

How Can We Help?





Example: Initial Evaluation to Determine Appropriate Level of Rigor



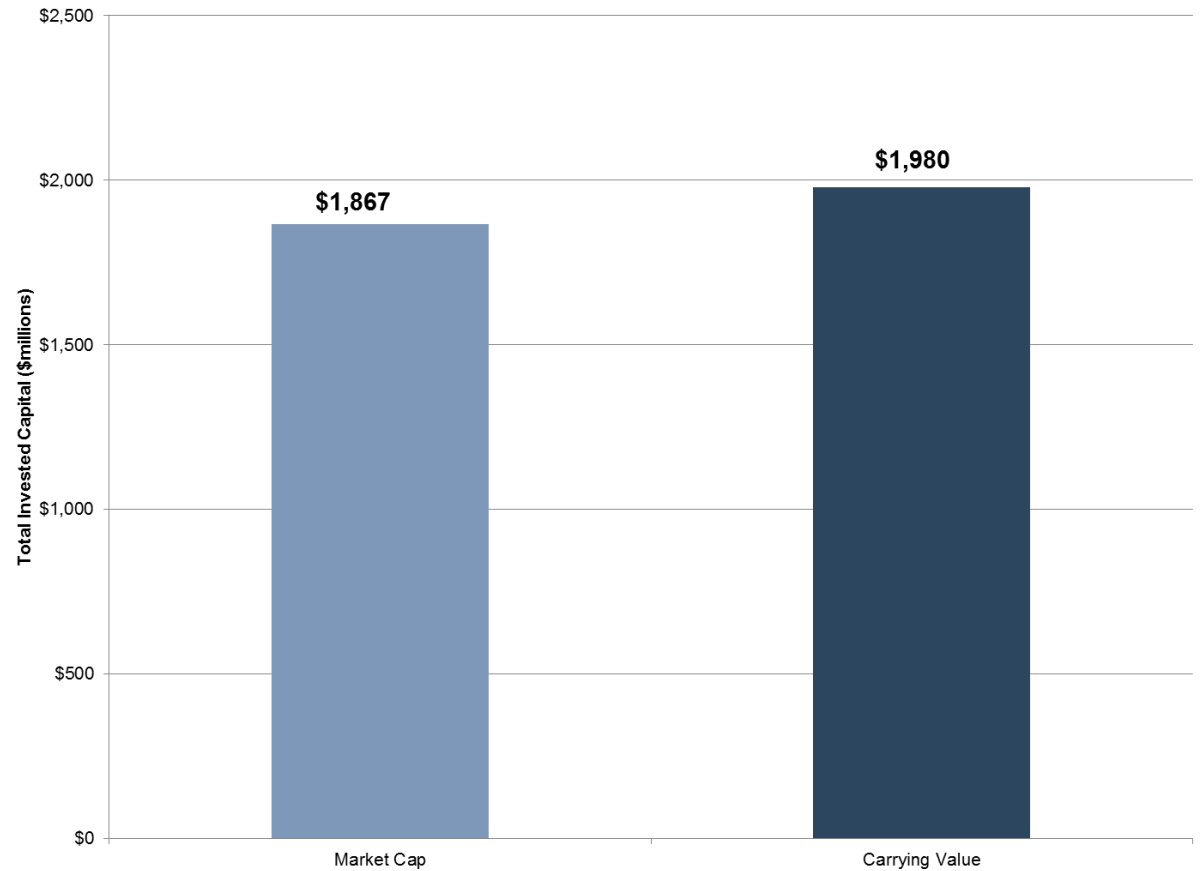
Calculate
Minimum
“Passing” MPAP

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graph TD; A[Calculate Minimum "Passing" MPAP] --> B[If Significant => Detailed Analysis]; A --> C[If Not Significant => Summary Analysis];
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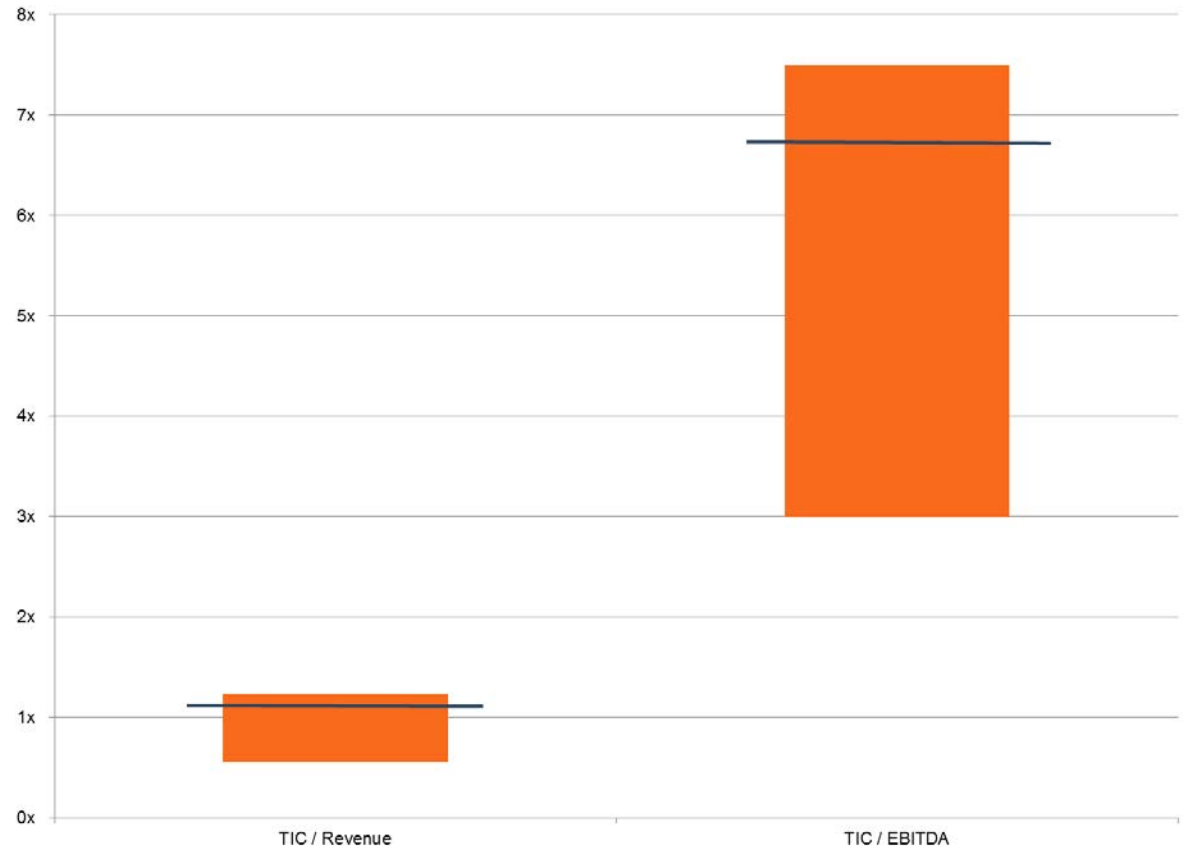
If Significant =>
Detailed Analysis

If Not Significant =>
Summary Analysis

Example: Scenario 1 (Detailed Analysis)



Example: Implied “Passing” Multiples Compared to Guideline Public Companies



Example: Economic Factors

Comparison of assumptions reveals three primary factors influencing MPAP:

- Enhance revenue due to larger distribution networks of market participants
- No meaningful cost savings identified
- Lower cost of capital due to financing advantages of market participants

	<u>Foundation Value</u>	<u>Fair Value</u>
Expected 5-yr CAGR (Revenue)	6.1%	8.0%
Gross Profit Margin	60.0%	60.0%
Operating Expenses:		
Research & Development	5.0%	5.0%
Distribution Expenses	13.5%	13.5%
Selling Expenses	17.5%	17.5%
Other General & Administrative	7.0%	7.0%
EBITDA Margin	17.0%	17.0%
Weighted Average Cost of Capital	10.5%	10.0%
Total Invested Capital	\$657	\$740
TIC / Trailing Revenue	1.1x	1.2x
TIC / Trailing EBITDA	7.1x	8.0x
MPAP Implied by Cash Flow Analysis		<u><u>12.6%</u></u>

Example: Assessing Revenue Synergies



How do the assumed market participant growth rates compare to guideline companies?

Factors that might be particularly relevant for revenue considerations

- Who are the market participants (strategic, financial, etc.)
- Size of market participants vis-à-vis target
- Stage in life cycle of subject entity
- State of industry acquisition activity
- Growth rate of peer companies
- Margins of peer companies
- Balance of information
- Capital structure of the target company
- Perceived quality of management
- Contingent consideration
- Regulatory factors

Example: Assessing Margin Enhancement



Going back to the factors discussed previously, items that might be particularly relevant for margin considerations

- Who are the market participants (strategic, financial, etc.)
- Size of market participants vis-à-vis target
- Stage in life cycle of subject entity
- State of industry acquisition activity
- Growth rate of peer companies
- Margins of peer companies
- Balance of information
- Capital structure of the target company
- Perceived quality of management
- Contingent consideration
- Regulatory factors

Example: Assessing Cost of Capital Effects



Going back to the factors discussed previously, items that might be particularly relevant for cost of capital effects

- Who are the market participants (strategic, financial, etc.)
- Size of market participants vis-à-vis target
- Stage in life cycle of subject entity
- State of industry acquisition activity
- Growth rate of peer companies
- Margins of peer companies
- Balance of information
- Capital structure of the target company
- Perceived quality of management
- Contingent consideration
- Regulatory factors

Example: Assessing Overall Reasonableness

Does comparison of the implied multiples to the guideline public companies reveal a coherent narrative?

Guideline Public Company Data

	LTM Revenue	LTM EBITDA	Projected EBITDA Margin	Est. 5-Yr Revenue Growth	Market Value (Invested Capital)	MVIC / Revenue	MVIC / EBITDA
Company A	\$29,000	\$5,220	18.0%	6.0%	\$31,320	1.08x	6.0x
Company B	\$5,100	\$893	17.5%	10.0%	\$6,248	1.23x	7.0x
Company C	\$13,200	\$2,508	19.0%	7.2%	\$13,794	1.05x	5.5x
Company D	\$2,400	\$408	17.0%	5.0%	\$2,040	0.85x	5.0x
Company E	\$9,000	\$1,170	13.0%	-2.0%	\$5,265	0.59x	4.5x
MEDIAN	\$9,000		17.5%	6.0%		1.05x	5.5x
AVERAGE	\$11,740		16.9%	5.2%		0.96x	5.6x
Subject Company			17.0%	8.0%		1.10x	6.5x

Example: Assessing Overall Reasonableness

Does comparison of the implied multiples to comparable transactions make sense?

Guideline Transaction Data

	LTM Revenue	LTM EBITDA	EBITDA Margin	Est. 5-Yr Revenue Growth	Transaction Value (TIC)	MVIC / Revenue	MVIC / EBITDA
Company F	\$4,500	\$788	17.5%	4.0%	\$5,513	1.23x	7.0x
Company G	\$7,800	\$1,248	16.0%	8.0%	\$9,360	1.20x	7.5x
Company H	\$9,000	\$1,170	13.0%	5.0%	\$7,020	0.78x	6.0x
MEDIAN	\$7,800		16.0%	5.0%		1.20x	7.0x
AVERAGE	\$7,100		15.5%	5.7%		1.07x	6.8x
Subject Company			17.0%	8.0%		1.10x	6.5x



Example: Assessing Overall Reasonableness

Is comparison to observed control premiums compelling?

Guideline Control Premiums

	Transaction Price Per Share	Shares Outstanding	Transaction Value (Equity)	Interest Bearing Debt	Transaction Value (TIC)	Unaffected Price Per Share	Observed Control Premium (Equity)	Observed Control Premium (TIC)
Company F	\$36.50	55.1	\$2,013	3,500	\$5,513	\$28.00	30.4%	9.3%
Company G	\$61.00	153.4	\$9,360	0	\$9,360	\$45.00	35.6%	35.6%
Company H	\$25.00	220.8	\$5,520	1,500	\$7,020	\$15.75	58.7%	41.0%
MEDIAN							35.6%	35.6%
AVERAGE							41.5%	28.6%



Is Control Premium Data Valuable?




Yes...


- Provides a composite view of the control benefits perceived (and paid for) by acquirers
- Helps establish the reasonableness of cash flow benefits assumed (or implied) by fair value measurement

... but the data cannot be relied on blindly

- Relative financial performance
- Implied multiples



Example: Initial Evaluation to Determine Appropriate Level of Rigor

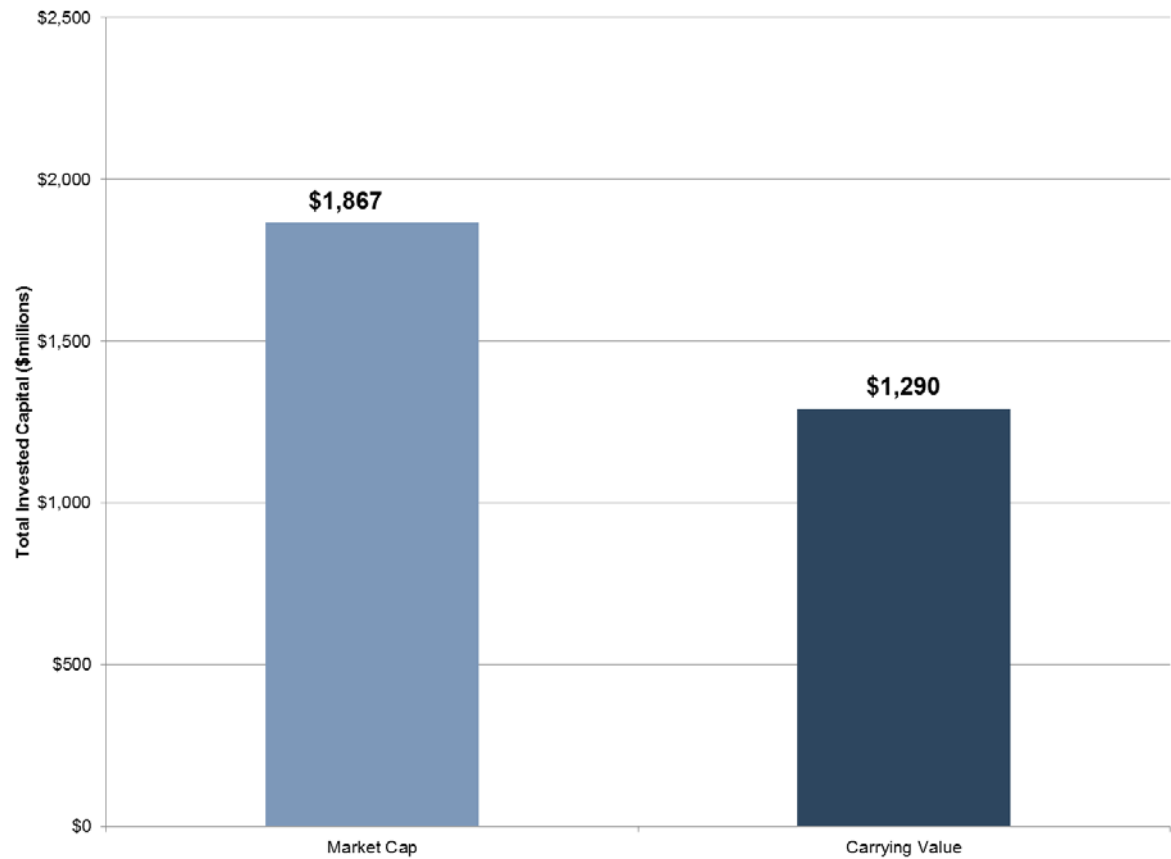


Calculate
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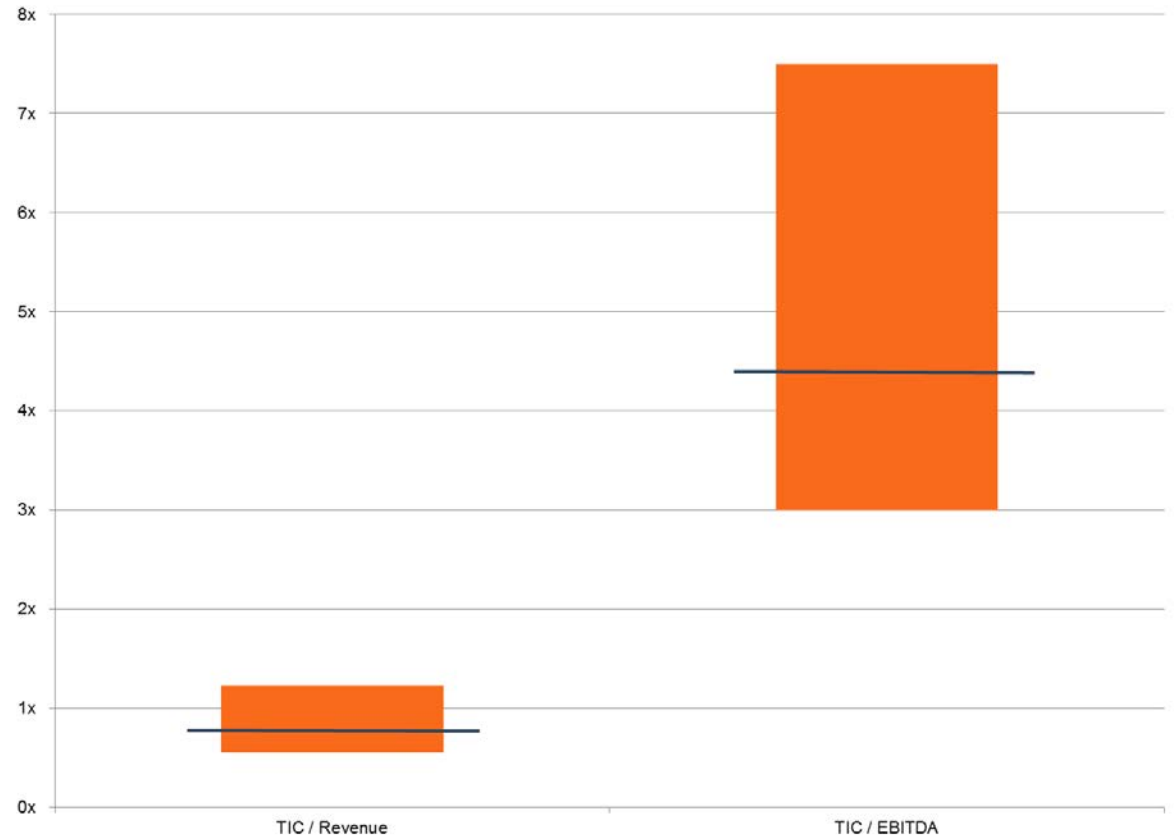
If Significant =>
Detailed Analysis

If Not Significant =>
Summary Analysis

Example: Scenario 2 (Summary Analysis)



Example: Implied “Passing” Multiples Compared to Guideline Public Companies



Example: Summary Analysis

- + Income Approach: Consider same synergies, but not necessary to make specific quantification
- + Market Approach: Same analysis prior to application of MPAP
- + MPAP Estimation: Preliminary estimate made with primary reference to guideline transaction control premium information likely sufficient



Q&A / DISCUSSION

What Do You Think?



About the Speaker



Travis W. Harms, CFA, CPA/ABV
Senior Vice President, Mercer Capital

901.685.2120

harmst@mercercapital.com

[linkedin.com/in/traviswharms](https://www.linkedin.com/in/traviswharms)

Travis frequently speaks on fair value accounting topics across the U.S. He is a member of The Appraisal Foundation's working group to address best practices for control premiums, and recently co-authored the book *Business Valuation: An Integrated Theory, Second Edition*, with Z. Christopher Mercer, ASA, CFA, ABAR published in 2008 by John Wiley and Sons, Inc.

