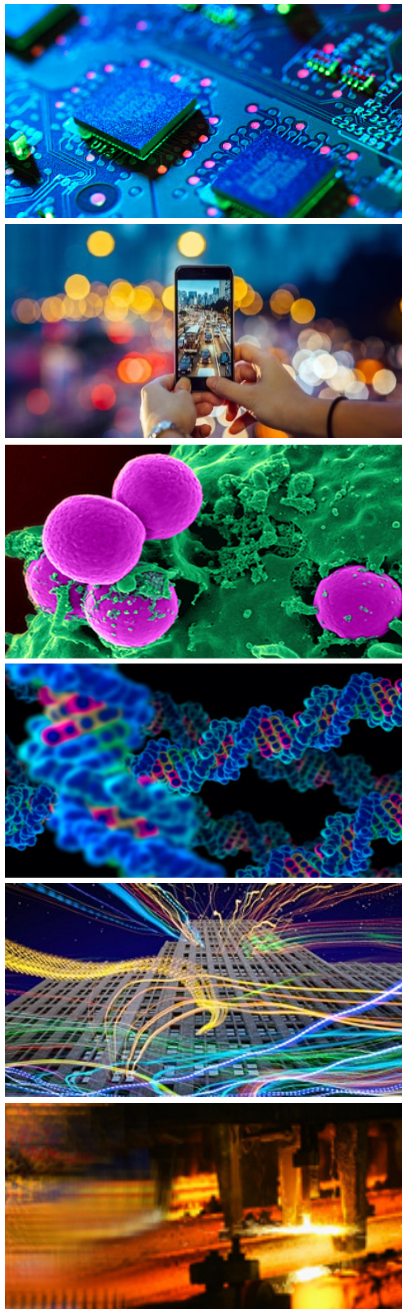


Globalview Advisors

Financial Valuation and Advisory Services

Select Valuation Topics of Interest to Financial Executives

Financial Executives Institute, San Diego Chapter

November 15, 2018

Contents

C to S Corporation Conversions – Tax Benefits

- Benefits of converting from a Subchapter C corporation to flow-through status (Subchapter S, LLC, LLP) include:
  - Avoidance of double taxation
  - Buyer gets to step up underlying tax basis of assets to their fair market value
    - Higher depreciation and/or amortization expenses reduce future taxable income and income tax expense.
- Benefits are generally agreed to by appraisers for the appraisal of controlling interest
- Due to potential for phantom income, the benefits associated with conversion from C to S status could actually lower the value of a minority equity position in certain cases
- Tax pass-through entities (excluding partnerships and sole proprietorships) increased from 24 percent of all U.S. corporations in 1986 to 69 percent of all U.S. corporations in 2008. REIT formations an example of recognition of tax benefits

C to S Corporation Conversions – “Claw Back”

- Tax Implications of Conversion
  - If sale of an S corporation occurs within five years of conversion, any gains will be taxed at ordinary income rate and not capital gain rate – plan well ahead of time
  - Certain assets held at time of conversion would be subject to net unrealized built-in gain (NUBIG) of the company or the assets as of the conversion date.
  - Other assets (typically depreciable / amortizable long lived assets) could generate net unrealized built-in losses (NUBIL). NUBIL can offset NUBIG

C to S Conversions – IRC 1374

- Under IRC Section 1374, a corporation making an S corporation election **should** obtain a valuation to determine the built-in gain – the appreciation in asset value from the period of time when the entity was a C corporation – as of the date of the S corporation election.
- If the S corporation subsequently sells any of these assets within the 5-year time period after its conversion from C corporation status (the recognition period), a built-in gain may be realized and the company will be liable to pay the highest corporate level tax rate on the gain as if it were a C corporation. Further, built-in gains attributable to intangible assets and goodwill may be subjected to tax, unless an S corporation can establish that such intangible assets are separable from goodwill and were acquired post S corporation election.
  - Existing vs. new customers
  - Existing vs. future technologies

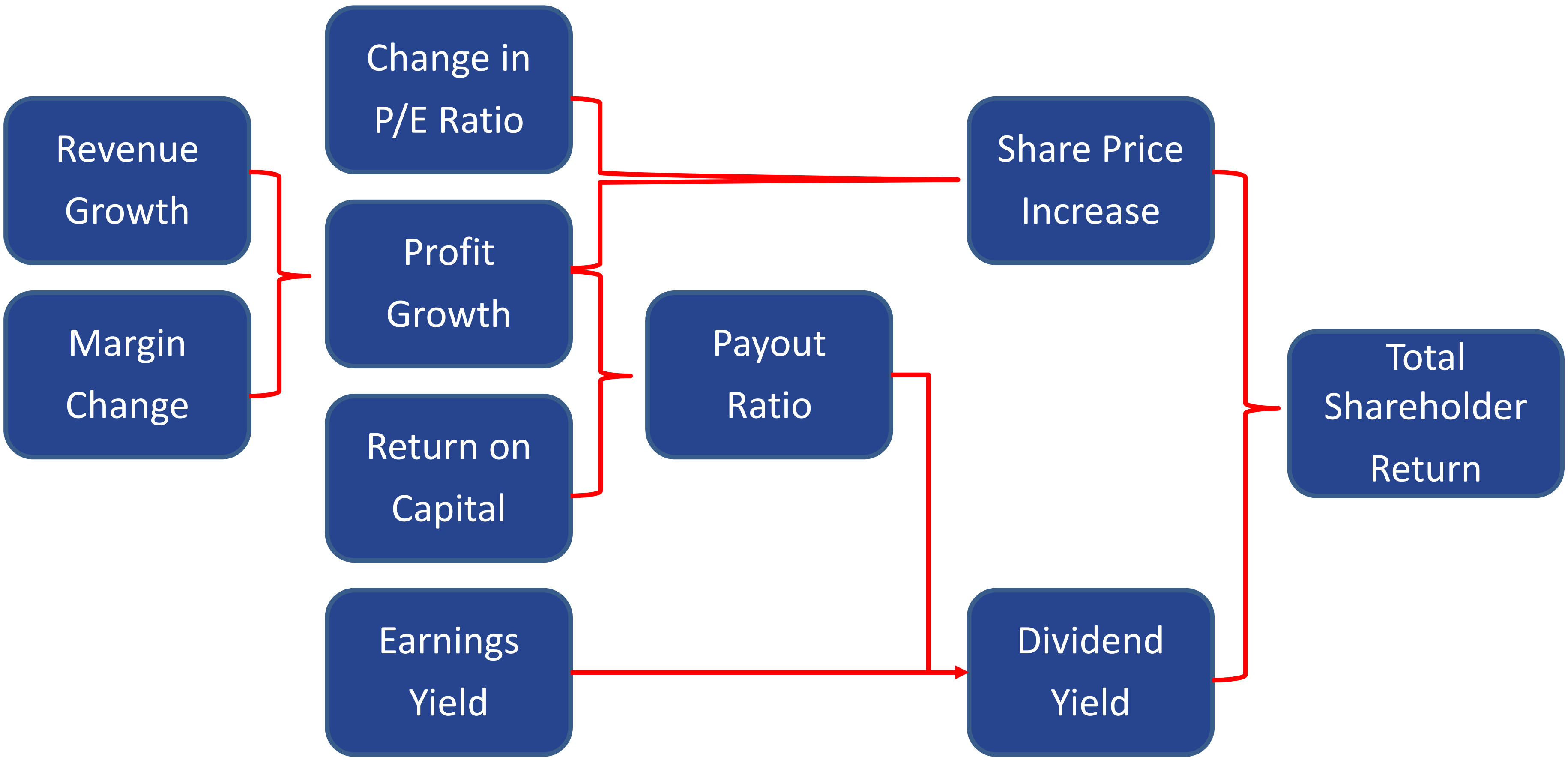
Selling Interests in Private Companies

- "Know what you own, and know why you own it." - Peter Lynch
- Common shareholders receive returns in the form of dividend income and capital appreciation.

$$R_0 = \frac{Div_1}{P_0} + \frac{(P_1 - P_0)}{P_0}$$

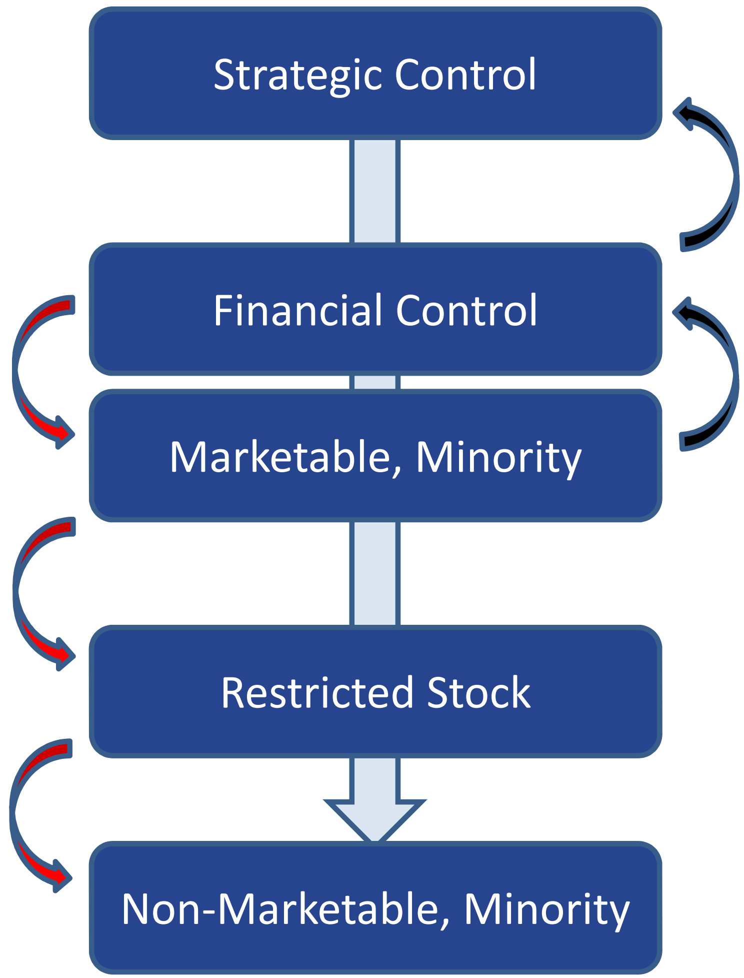
- For private companies, the challenge lies in the control and/or timing of dividends and *realizing* a capital gain.
- “It’s good to be the king!” – Mel Brooks (*History of the World*)
  - Prerogatives of control include developing and implementing strategy, setting compensation and dividend policies as well as initiating liquidity events.
  - As such, the value of a controlling interest is often greater than a minority interest.

Drivers of Total Shareholder Return



Source: *Valuation: Measuring & Managing the Value of Companies* (Kindle - University 6th Edition), Koller et. al., Exhibit 4.3.

Economic Measures of Control



Value of control can be enhanced by way of unique synergies

Market participant acquisition premium may be justified

Discount for lack of control may be justified

Discount for lack of marketability is appropriate with recognition that restrictions will be lifted

Larger DLOM is appropriate given that limitations on marketability may never be resolved

Shareholding Levels & Control

Control

100% Equity Interest

Liquidating Control Interest

51% Equity Interest

Two 50% Equity Interest

Largest Block Minority Shareholder

Swing Vote Minority Shareholder

Cumulative Voting Rights Minority Shareholder

Minority

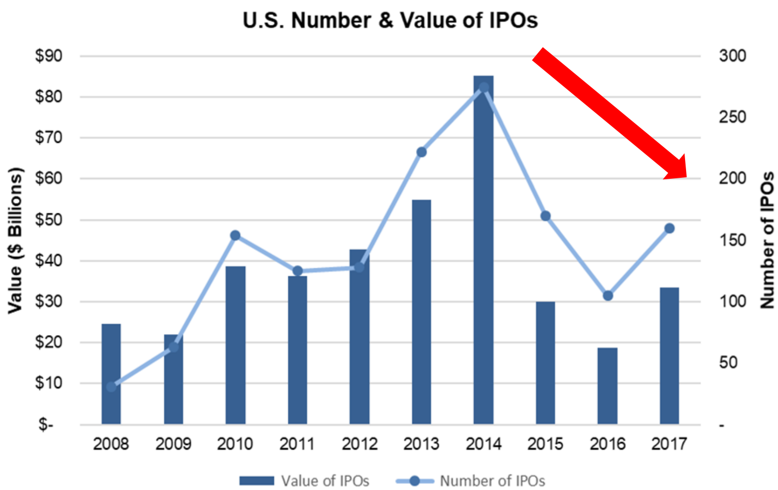
Minority

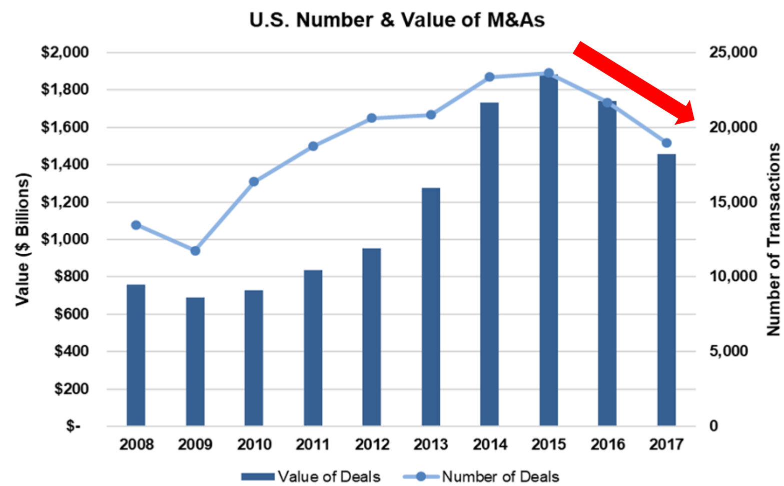
Sale, M&A, recap, drag along rights

Dissolution action, appraisal rights, oppression, tag-along rights

Liquidity for Private Companies

- Historically, holders of a minority interest placed their hopes on a liquidity event in order to realize appreciation in their investment.





- Many companies have decided to stay private longer due to volatile public markets and burdensome regulatory and compliance obligations.
- Absent a company-wide liquidity event, minority shareholders may achieve liquidity by way of a limited number of paths:
  - Negotiated secondary sales
  - Structured liquidity programs (e.g., private tender offers of stock)
  - Loans, derivatives and synthetics

Secondary Sales

- Over the past 15 years, platforms have emerged to provide liquidity to minority interests in privately held companies by connecting investors and shareholders
  - NASDAQ Private Market (“NPM”, formerly SecondMarket)
  - SharesPost
  - EquityZen
- NPM declares that private company liquidity has gone mainstream
  - 1H 2018 transaction volume $10B compared to $0.7B in 1H 2017
  - There were 33 total programs (20 3rd party, 13 buybacks) in 1H 2018 compared to 19 (7 3rd party, 12 buybacks) in 1H 2017
  - Median deal size increased to $18.3 million from $12.8 million
  - 50% of transactions are in companies with valuations <$1 billion
  - Two-thirds of transactions occur in companies with <250 eligible shareholders

Secondary Sales

- Notwithstanding the excitement of gaining pre-IPO liquidity, secondary sales of minority shares pose a number of challenges
  - Management distraction
  - Unfair economic results if only certain shareholders are able to transact
  - New shareholder relationships
  - Tax treatment of spread above 409A valuation
  - Disclosure requirements
  - Investor rights and restrictions and obligations of shares

Structured Liquidity Programs

- Company facilitates liquidity for a larger group of shareholders.
- Addresses some of the distraction, fairness and relationship concerns of unrestrained secondary market transactions.
- Generally pursued by more mature private companies that have long-term shareholders.
- Repurchase comes in the form of tender offers by the company or third parties in connection with new financing
  - Direct purchase of shares or allocation to repurchase shares

Impact of Secondary Sales / Liquidity Programs

- Secondary sales and/or company sponsored liquidity programs would impact the valuation of minority shares in two ways:
  - Overall equity value. Arms-length transactions in the company's stock (Prior Transactions Method) should be evaluated as an indicator of value along with other relevant valuation methods (e.g., Discounted Cash Flow Method).
  - The magnitude of any applicable discount for lack of marketability (DLOM):
    - Factors considered include:
      - Prospects for a liquidity event
      - Transfer restrictions and duration thereof
      - Pool of potential buyers
    - Existence of a market for secondary sales or a company-sponsored liquidity program would lower the DLOM.

Valuation Discounts and Premiums - Introduction

- Equity interests in private companies are often illiquid with limited number of potential buyers (VC or PE backed firms may be an exception)
- If the equity interest is 100% of the equity of a firm or a controlling equity interest, the potential market would consist of:
  - Strategic buyers (if any)
  - Financial buyers
- Sale of the total equity of a firm could take several months (or longer) to accomplish
- Absent expectations of a future liquidity event, the market of buyers for a small minority interest in a private firm is often very limited
- Risks associated with a minority interest in a private firm include:
  - Potential for actions by the controlling shareholders that reduce the returns to minority shareholders (disproportionate returns)
  - Uncertainty of time until a liquidity event
  - Numerous other

Valuation Discounts and Premiums - Key Factors

- The potentially reduced value of a minority interest may consider adjustments for
  - Lack of control
    - Change terms of controlling documents
    - Elect / remove management
    - Set policy
    - Determine course of business
    - Determine distribution policy
    - Sell or dissolve entity
  - Limited marketability
    - Distribution levels
    - Potential for phantom income
    - Timing of a liquidity event

Control Premiums and Lack of Control Discounts

- Value associated with acquiring a firm is best measured through analysis of incremental cash flows to buyer
- Applying a percentage premium based on measurement of premiums paid to buy public companies is not best practice
- SEC viewpoint is that control discounts, if any, should reflect disproportionate returns received by minority shareholders
- Firms striving for a liquidity event may not have disproportionate returns due to focus on achieving liquidity
- Disproportionate returns is much more likely for firms with little potential for IPO or strategic acquisition. These firms often do NOT have PE/VC backing and liquidity focus

Valuation Discounts – Measurement Insights

- For a control discount, measure the diminution of value due to adverse actions by control group
  - Actual vs. potential
- For a lack of marketability discount, option models are becoming increasingly popular (Finnerty Model).
  - Holding period - As time to liquidity increases, risk and discount increases. Same for volatility
  - Volatility – As asset value becomes more volatile, the adverse impact of not having liquidity becomes more important (little risk and volatility in the principal value of a U.S. treasury obligation)
- Lack of marketability can also be estimated based on transactions involving restricted stock
  - Limited transactions in restricted stock make it hard to find “good comps”

Impact of TCJA on Valuations

- Impact of TCJA
  - Change in cost of capital
    - Lower tax rate increases after tax cost of debt
    - Interest deductibility limitations increase cost of debt
  - Numerous short term changes that may sunset –use of simplified models can be challenged
    - Bonus depreciation (100% write off through 2022 – gradual phase out until 2027). Bonus depreciation includes fixed asset acquired in a business combination
  - Complexities associated with
    - Interest deductibility
    - R&D expense deduction under IRC 174 capitalized and amortized over 60 months (begins in 2022)
    - Tax rate calculation

Summary of TCJA Impacts

Business Characteristic	Generally Lower Tax Burden	Generally Higher Tax Burden
HQ jurisdiction	Domestic	Non-U.S.
Use of leverage	N/A	High
Fixed asset spend	High	N/A
Location of IP	Domestic	Offshore
Payments to non-U.S. affiliates	N/A	Significant
Use of incentives and credits	N/A	High dependence

TCJA – Revisions Specific to Intangibles

- Elements of the TCJA directly impacting intangibles include:

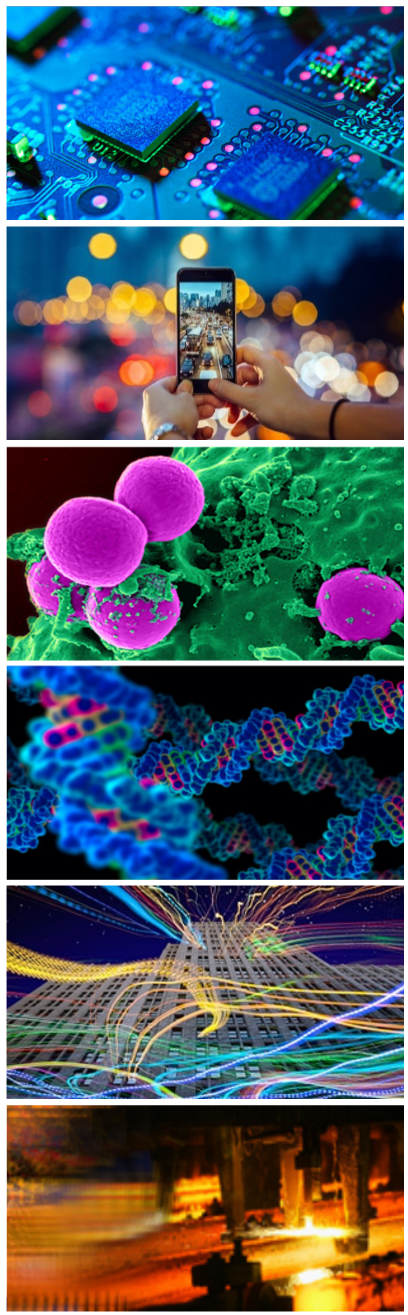
1. **IRC 174** – Research and Experimentation deductibility to be revised after CY 2021 from immediate expensing to capitalization and amortization model (Move from immediate deduction to tax amortization over five years (US) or fifteen years (foreign))
2. **IRC 250** - U.S. owned intellectual property receives favorable tax treatment for any Foreign-Derived Intangible Income (Reduction of tax rate in certain instances)
3. **IRC 951A - Global Intangible Low Tax Income ("GILTI")** – Income of a foreign controlled corporation is subject to U.S. tax (Potential increase in tax base and tax payments)
4. **Base Erosion and Anti-Abuse Tax ("BEAT") –** Alternative tax calculation
5. **Transfer Pricing Revisions** - Expands definition of intangibles for TP determinations
6. **IRC 861 / 864** – Elimination of fair market value option

Valuation Profession Developments

- A new designation, *Certified in Entity and Intangible Valuations (CEIV),* was first offered in mid-2017.
- As part of the development of the CEIV, two documents with guidance on minimum valuation procedures to perform were issued including:
  - Mandatory Performance Framework (MPF)
  - Application of Mandatory Performance Framework (AMPF)
- The MPF / AMPF include certain minimum work requirements that need to be performed and documented for certain valuations performed for financial reporting.
- Given SEC involvement and involvement of the major valuation professional organizations (AICPA, American Society of Appraisers, Royal Institute of Chartered Surveyors), the relevance of the MPF/AMPF as minimum procedures for valuations prepared for purposes other than financial reporting projects should be assessed.

Other Valuation Developments

- FASB change to fair value disclosures
- FASB considering revised accounting requirements for goodwill
- Impact of revenue and leasing standards – may change income statements and balance sheets of guideline public companies
- New valuation guidance
  - PE/VC portfolio company valuation guide – final issuance expected in mid 2019 – draft released May 2018
  - AICPA Business Combinations Guide
    - Inventory valuation for ASC 805
    - Intangible asset guidance
  - Contingent consideration guide – final guide expected in near future



Questions

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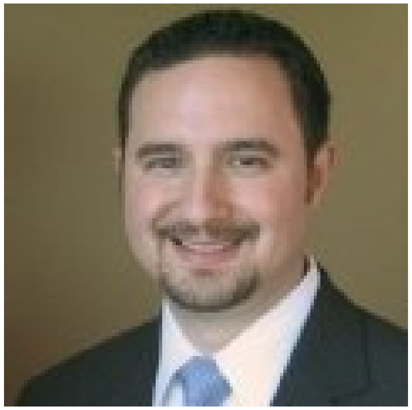
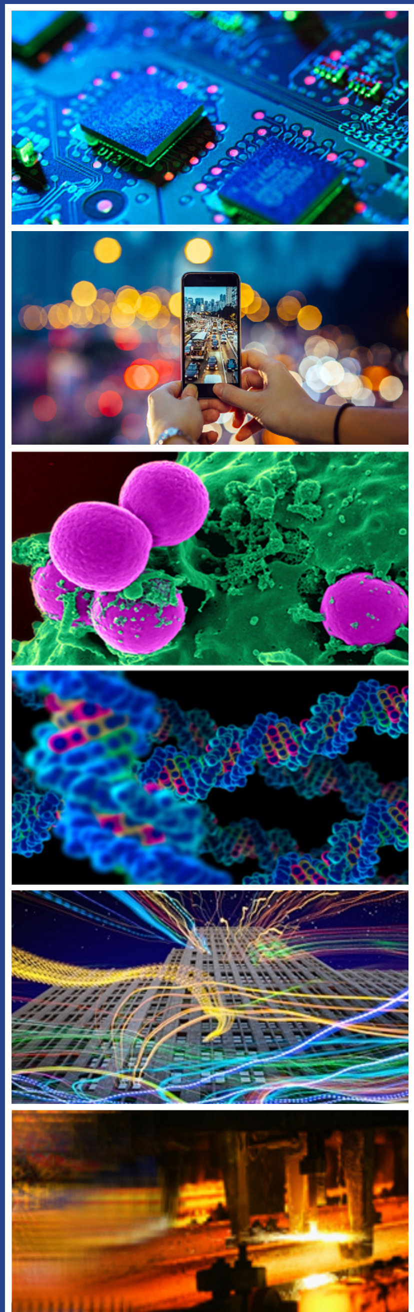
Raymond Rath, ASA, CFA Globalview Advisors

- Ray is a Managing Director in the Irvine, California office of Globalview Advisors. He has over 30 years of financial valuation expertise in the valuation of businesses, securities interests, and intangible assets.
- Ray has performed valuation projects for financial (both US GAAP and IFRS) and tax reporting, transactions, and litigation projects. In addition to performing valuations, Ray has extensive experience in the review of third-party and management prepared valuations.
- Ray has a wealth of experience in a wide range of industries. In recent years, much of his work has focused on technology and Internet firms. Other industries where he has significant project expertise include consumer products, entertainment and media, food services, health care, and manufacturing, in addition to early stage, rapid growth firms.
- Prior to joining Globalview Advisors in 2012, Ray was a Director in the Valuation Services Practice at PricewaterhouseCoopers LLP. He was also a Senior Manager in the Valuation Services Practice at KPMG LLP and KPMG Consulting, Inc., as well as a Manager at Arthur Andersen & Company.
- Ray received his MBA from the University of Southern California and his BS in Business Administration, cum laude, from the University of Kansas. He is an accredited senior Member of the *American Society of Appraisers (ASA)* in the business and intangible assets valuation disciplines as well *as* Appraisal Review and Management, and is also a Chartered Financial Analyst (CFA).

Jeremy Burnstein, Globalview Advisors



- Jeremy is a Director in our Irvine Office. He has over 15 years of valuation experience involving business enterprises, capital stock, and intangible assets for various purposes including allocations of purchase price, corporate acquisitions and divestitures, fairness and solvency opinions, fresh start accounting, goodwill impairment, litigation, and financial and tax reporting.
- Jeremy has served clients in various industries including agriculture, coal mining, computer equipment and software, construction and engineering, consumer products, contract research services, energy, food processing, heavy equipment rental, higher education, Internet-based businesses, medical supplies distribution, metal processing and recycling, pharmaceuticals, real estate development and REITs, semiconductor, specialty retail, and telecommunications equipment and services.
- Jeremy received his MS in Finance from Seattle University and his BA in Business Administration from California State University, Fullerton. He also holds a certificate in Strategic Decision and Risk Management from Stanford University. Jeremy is a Certified Valuation Analyst (CVA), is Certified in Entity and Intangible Valuations™ (CEIV™) and is also Chartered Financial Analyst (CFA®) charterholder.



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