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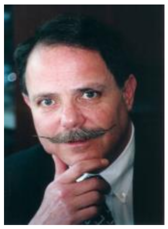
The Franchise Valuations Reporter

Franchise Technology Risk Management

Our Expertise



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Bruce S. Schaeffer, Editor
Bruce@FranchiseValuations.com
212.689.0400

Franchise Technology Risk Management

Our franchise law and computer forensics experts provide consulting and implementation of all aspects of cyber security, ESI management and e-discovery for franchise systems - from preparation of cyber security and ESI-related policies and procedures manuals through collection, preservation, processing, production and presentation.

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Valuation of LLCs

Estate of Gallagher v. Commissioner

In *Estate of Gallagher*[1], a case which was decided in 2011, the Tax Court provided a primer on valuing interests in closely held entities, an issue that has broad application for all franchisors and franchisees - including those that are publicly held. In *Gallagher*, the Court held that the value of a decedent's interest in a limited liability company (LLC) should be determined by using the discounted cash flow (DCF) method absent exceptional information on "comparable" entities.

The decedent held a 15-percent ownership interest in the LLC, which owned 41 newspapers and other publications, which her estate valued at $34.9 million; the IRS determined the value was $49.5 million. The IRS's expert used a "market" based approach in addition to the DCF method but the Tax Court found that the four companies he used as "comparables" (1) were not sufficiently similar; and (2) there were not enough "comparables" statistically to avoid distortion.

Thus, the Tax Court ruled that the DCF method alone should be used and that discounts of 23 percent for a minority interest and of 31 percent for lack of marketability were permitted.

And here's what the Court said on some other issues:

1. Expert Opinions:
"[Parties] rely principally on expert testimony to establish fair market value . . . Valuation is a question of fact. [citation omitted]. Courts often consider expert witnesses' opinions in deciding such cases; however, we are not bound by the opinion of any expert witness and may accept or reject such testimony in the exercise of our sound judgment. [citation omitted]. Although we may accept an expert's opinion in its entirety, we may instead select what portions of the opinion, if any, to accept. [citation omitted] Because valuation involves an approximation, 'the figure at which we arrive need not be directly traceable to specific testimony if it is within the range of values that may be properly derived from consideration of all the evidence.' [citation omitted]"

2. Guideline Company Methodology
This method was rejected by the Court in this case because: "[the IRS expert] failed to analyze sufficiently comparable publicly held companies to warrant application of the guideline company method herein. Publicly held companies involved in similar, rather than the same, lines of business may act as guideline companies. . ." However, "As similarity to the company to be valued decreases, the number of required comparables increases in order to minimize the risk that the results will be distorted by attributes unique to each of the guideline companies." [citation omitted]. While the small number of guideline companies chosen by [the IRS expert] are engaged in business ventures similar to [the taxpayer's], their differences from [the taxpayer] prevent a reliable comparison."

3. Other Issues:
The Opinion also addresses the proper use of the DCF method in great detail and the effects of: appropriate adjustments; projections, computations and

We Write the Book

Franchise Regulation and Damages, the only treatise that covers valuations of franchises, is updated 3 times a year.

For more details, to see a Table of Contents or to place an order, go to the Wolters Kluwer Law & Business web page here.

DISCLAIMER

The information provided in this newsletter is for informational purposes only and should not be construed as legal or expert advice which can only be obtained from appropriate professionals. Franchise Valuations, Ltd. and Franchise Technology Risk Management provide such expert advice on the topics addressed herein.

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tax affecting (not properly pled in this case so the issue was ignored); and capital expenditures.

Also the decision discussed and defined three common methods of determining the proper discount rate (or rate of return expected by an arm's-length investor) as follows:
a) WACC (Weighted Average Cost of Capital). Expressed the WACC formula as: WACC = ((Ke)*(%E) + ((Kd*(%D)*(1-t)) Where: WACC = weighted average cost of capital; Ke = leveraged cost of equity; %E = percent equity in capital structure; Kd = average cost of debt, %D = percent debt in capital structure; and t = marginal tax rate.

> b) CAPM (Capital Asset Pricing Model) "is used to estimate a discount rate by adding the risk-free rate, an adjusted equity risk premium, and a specific risk or unsystematic risk premium. The company's debt-free cash-flow is then multiplied by the discount rate to estimate the total return an investor would demand compared to other investments." *Estate of Klauss v. Commissioner* [Dec. 53,923(M)], T.C. Memo. 2000-191 n.10.
>
> c) Build Up Method. "Under the build-up method, an appraiser selects an interest rate based on the interest rate paid on governmental obligations and increases that rate to compensate the investor for the disadvantages of the proposed investment." *Id.* n.11.

The entire opinion can be accessed here.

[1]102 TCM 388, TC Memo 2011-244 (June 28, 2011)

Valuations: ESOPs under Government Scrutiny. Are Rollovers Next?

Valuations Are Focus of Inquiries - Workers Victimized by Lax Regulation and Fraudulent Appraisals

The Wall Street Journal reports the federal government is stepping up scrutiny of the way U.S. companies are valued for employee-stock-ownership plans, known as ESOPs. In 15 pending lawsuits the government is alleging shoddy estimates of what a company's shares are worth. "Since the start of fiscal 2010, the Labor Department has recovered over $241 million through suits or investigations that were resolved without going to court, nearly all of which involve valuations. Overall, the agency has filed 28 suits tied to employee-stock-ownership plans since October 2009, double the total in the previous six years, according to an internal tally reviewed by *The Wall Street Journal*."

ESOPs rely on appraisers to provide valuations when a stock plan is started and annually thereafter. But the U.S. Labor Dept., which regulates such plans, has yet to establish minimum qualification standards for these appraisers or specific rules on how they perform their work. In testimony before Congress earlier this year, Labor Secretary Thomas Perez stated the some appraisals "have been deliberately inflated," comparing them to home appraisals conducted during the era of the real estate bubble that "masterfully came in at what you needed."

This lack of regulation may soon change. In a settlement reached early in June 2014 with GreatBanc Trust Co. the government set out certain practices designed to protect workers from harm due to shoddy valuations. As part of the $5.3 million deal, the trustees agreed to take "reasonable steps" to insure the appraiser is receiving accurate and current information and must "prudently investigate" the appraiser's qualifications.

With about 6,800 plans in existence, mostly in closely-held companies, over 13.4 million workers who participate in ESOPs are affected. At about a third of those companies, the ESOP is the only retirement benefit offered.

One can only wonder how soon this initiative will include a study of the competence of the valuations used in IRA and 401(k) ROBS (Rollovers as Business Start-Ups) such as those so often offered as financing for franchisees.

Modest Improvements Seen In Restaurant Financing Outlook

Multiples Up and Cap Rates Down But Lenders Remain Cautious

In its 12th annual restaurant finance report Restaurant Research LLC found an increase in loan originations, a decline in borrowing rates and an improvement in EBITDA valuation multiples for large restaurant chains in 2013. Based on a survey of 39 finance companies the report highlights changes in origination volume, portfolio size, key rates, equity requirements, leverage ratios, loan and amortization terms, EBITDA multiples and real estate cap rates for the period 2009 through 2013.

Among its noteworthy findings on valuation trends:

- Unit level EBITDA valuation multiples for restaurants affiliated with large chains continued their modest, but steady improvement over the last 2 years and are expected to increase further over the next 6 months, driven by favorable lending terms and capital availability. However, overall valuations will likely fluctuate on a concept by concept basis depending on unit level economic performance.
- Cap rates appear to have leveled off and are trending slightly higher, but remain near historic lows due to limited supply and favorable financing terms.

Restaurant Research LLC provides clients with restaurant store level data for $1B+ chains obtained through its extensive network of restaurant industry players. For more information on its reports and pricing, go to their [website](#) or call (203) 938-4703.

Cybersecurity: Quantifying Business Risk

Clean-up Costs Continue To Mount

So far this year, 1,517 publicly traded companies listed some version of the words cybersecurity, hacking, hackers, cyberattacks or data breach as a business risk in securities filings, according to a *Wall Street Journal* analysis. That is up from 1,288 in all of 2013 and 879 in 2012.

Still, most companies involved in franchising ignore the threat of Internet intruders and seem ignorant of the potential costs and damages. Well, it's time to face it! The out-of-pocket cost from a data breach could be enormous - even to the point of putting a company out of business. According to the Ponemon Institute the *average* costs this year are:

*** data breach = $5,850,000.**
*** detection and escalation costs = $417,700.**
*** notification costs = $509,237.**
*** post data breach costs = $1,599,996.**
*** lost business costs = $3,324,959.**

Cybersecurity and Law Firms
Lawyers and their firms face almost as many threats as other businesses - maybe more. In particular they are at risk from disgruntled employees or quick buck artists. For cautionary tales see Ed Finkel, "Inside Out Threat", *ABA Journal* July 2014.

Cybersecurity

More Reasons to Harden Your Network

Links to Recent Articles on Cyber-Crime

Corporate Boards Race to Shore Up Cybersecurity