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BCC Advisers Litigation & Valuation REPORT

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Franchises present unique valuation challenges

A franchise may need to be valued in several contexts, including mergers and acquisitions, estate planning, divorce, taxation and litigation. In many respects, valuing a franchise is just like valuing any other type of business, but it also requires a valuator to consider several factors unique to the franchise business model.

Here's a brief summary of these factors. For purposes of this article, we'll focus on valuation of a "single-unit" franchisee — that is, a franchisee that obtains rights to operate one franchise location. Additional factors come into play in the valuations of franchisors or multiple-unit franchisees.

Franchise agreement is the key

In a typical franchise arrangement, the franchisee obtains the exclusive right to sell the franchisor's product or service within a specified geographic area. The franchisee enjoys the benefits of the franchisor's brand name, business plans, marketing program, systems, processes, operations manuals, training and support. In exchange, the franchisee pays the franchisor royalties, advertising allowances and other fees.

Restrictions imposed by the franchise agreement may diminish a franchise's value relative to comparable standalone businesses.

It's tempting to conclude that a franchise is more valuable than a similar independent business with comparable earnings or cash flow. After all, the franchisee gains instant access to the franchisor's proven business model and brand identity, which

reduces the franchisee's risk. But many franchisors place significant restrictions on a franchisee's activities or pressure them to make periodic facilities improvements, which may have an impact on value.

The key to valuing a franchise is to analyze the franchise agreement, which sets forth the parties' relative rights and obligations. It's also necessary to review the franchisor's Franchise Disclosure Document (FDD). The Federal Trade Commission requires franchisors to provide an FDD to franchisees at least two weeks before they sign a franchise agreement. It contains detailed information about the franchisor's business, including its executives' business experience, its arrangements with franchisees, its financial performance, its litigation and bankruptcy history, and its intellectual property.

Factors that add value

Several aspects of the franchisor-franchisee relationship reduce the franchisee's risk and, therefore, enhance the value. As noted above, franchisees benefit from the franchisor's brand name and reputation — as well as from a variety of time-tested tools, systems, processes and support — giving them a valuable head start over comparable independent businesses. In addition, many franchisors handle the majority of the marketing for their franchises, freeing up their franchisees to focus on other aspects of business operations.

Franchisees may also enjoy cost savings through access to the franchisor's volume purchasing arrangements. And the franchisor's established business systems can help franchisees enhance quality and efficiency. For example, many franchisors offer access to cloud-based, integrated point-of-sale and accounting systems that provide franchisees with powerful financial tools and real-time business performance information.

Factors that may diminish value

Despite the advantages that franchising offers, such as product consistency customers can rely on, restrictions imposed by the franchise agreement may diminish a franchise's value relative to comparable standalone businesses. For example, franchise agreements typically restrict franchisees to a defined geographic territory, limit the products and services they can offer, and control the prices they charge. All of these constraints can inhibit a franchisee's ability to expand and grow.

The franchisor's handling of marketing can be a double-edged sword. The franchisor's marketing program is a significant benefit, but many franchise agreements prohibit franchisees from doing their own marketing. This deprives franchisees of the opportunity to tailor their marketing efforts to the specific locale and changing conditions of their local markets or otherwise to differentiate themselves from the competition.

Restrictions on the franchisee's ability to sell or otherwise transfer the franchise may also diminish its value. Many franchise agreements require franchisor approval of a proposed transfer, and some impose additional conditions, such as refurbishment of the franchise facilities or payment of a transfer fee. Other agreements give the franchisor a right of first refusal. Although the franchisee has the right to transfer the franchise if the franchisor declines to exercise its right of first refusal (usually within 30 or 60 days), the existence of the right may deter potential buyers from making an offer.

Value with care

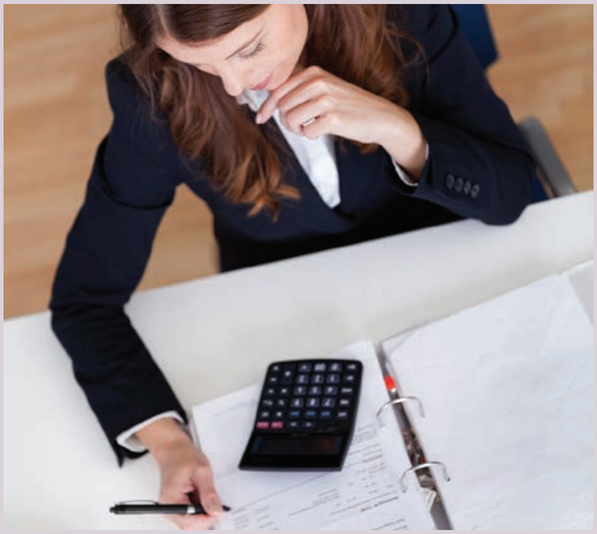
These and other factors make valuing franchises more complex than valuing comparable standalone businesses. In general, investors prefer more franchise-friendly agreements to those that are highly restrictive.

To arrive at an accurate value, appraisers analyze the franchise agreement and evaluate the terms that have a positive or negative impact on value — and, if possible, compare it to other franchisors' agreements. ◆

WATCH OUT FOR MARKET MULTIPLES

When valuing a franchise, valuators are careful not to accept market multiples without close analysis. Multiples may serve as a rule of thumb and provide a ballpark estimate of value, but as an indicator of actual value they're only as good as the underlying data. Multiples based on actual sales of other franchises of the same franchisor are the best indicators of value, but this data may be hard to come by.

Absent a reasonable number of comparable sales involving the same franchise brand, remember that every *franchisee* is different. So there's no substitute for analyzing the franchise agreement and other factors that drive a particular business's value.



Ferolito v. AriZona Beverages USA LLC

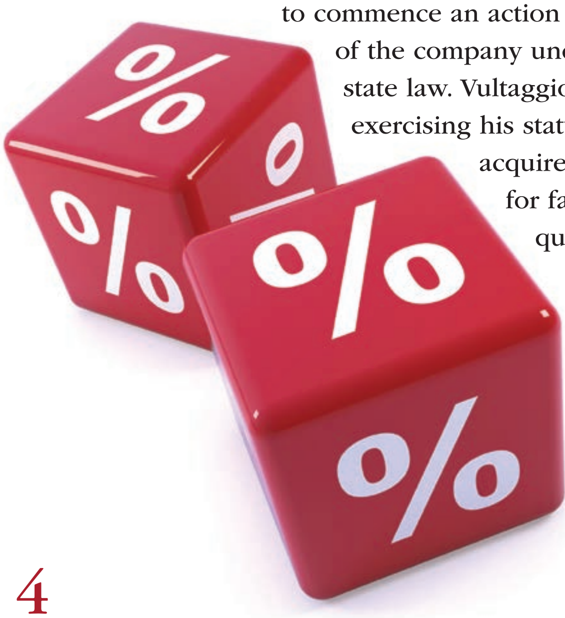
Are marketability discounts warranted in fair value litigation?

A recent case involving a dispute between the two equal owners of AriZona Beverages USA LLC (AriZona), the largest privately owned beverage company in the United States, addressed several interesting valuation issues. In establishing the fair value of a 50% interest in AriZona, the New York Supreme Court (Nassau County) determined that the discounted cash flow (DCF) method was the only reliable valuation method and set the discount for lack of marketability (DLOM) at 25%, among other conclusions.

Case history

John Ferolito and Domenick Vultaggio founded AriZona in 1992 as equal owners. After a series of disagreements, they agreed that Vultaggio should run the company's day-to-day operations. They also entered into an owners' agreement that prevented the owners from transferring interests to outsiders without the other owner's consent.

Although AriZona flourished under Vultaggio's leadership, Ferolito wanted to sell his shares. His efforts to consummate a sale were thwarted, leading him to commence an action for dissolution of the company under New York state law. Vultaggio responded by exercising his statutory right to acquire Ferolito's shares for fair value. A subsequent court ruling allowed the company, rather than Vultaggio, to repurchase the plaintiff's interest.



Valuation issues

The plaintiff's valuation expert claimed that the company was worth approximately $3.2 billion, while the defendant's expert countered with a claimed value of $426 million for the company. The court discussed a variety of valuation issues in its 42-page opinion, including:

Valuation method. The defendant's expert relied exclusively on the DCF method, while the plaintiff's expert assigned an 80% weight to DCF and 20% to a comparable transactions analysis. The court sided with the defendant, finding that AriZona is truly an "incomparable" company and that "any attempts to find comparable companies are truly lacking." Reasons for this conclusion include the company's extremely advantageous position in the ready-to-drink tea market and constant disputes between the owners.

The court also rejected the argument that a valuator should consider the company's strategic or synergistic value to a hypothetical buyer, finding such an approach to be unduly speculative.

Purchase offers. Over the years, several parties had expressed interest in acquiring all or part of AriZona, including competitors Tata and Nestlé. Tata, for example, estimated the company's value to be as high as $4.5 billion, while Nestlé proposed to acquire Ferolito's interest for $1.45 billion.

The court found these offers to be unreliable indicators of value because, among other things: Neither suitor had conducted appropriate due diligence, neither had obtained board approval and AriZona's lack of audited financial statements made it difficult for them to finalize an offer.

DLOM. The defendant's valuation expert applied a DLOM of 35%. The plaintiff's expert argued that no DLOM was necessary, because the company had been successful and other companies had expressed an interest in acquiring it. New York law doesn't allow minority interest discounts in determining fair value, but, unlike many states, it does permit a DLOM.

Whether a DLOM is warranted in fair value litigation depends on state laws, relevant legal precedent and the facts of the case.

In accepting a 25% DLOM, the court cited the recent New York case, *Zelouf International Corp. v. Zelouf*. In that case, the court rejected a DLOM because the company was unlikely to ever be sold and "any liquidity risk … is more theoretical than real."

The court opined that Ferolito's difficulty in selling his interest reflected the company's lack of marketability. Contributing factors included transfer restrictions in the owners' agreement, the company's lack of audited financial statements, litigation between the owners and uncertainty about the company's continued S corporation status.

Based on its detailed DCF analysis and "back-of-the-envelope" calculations, the court concluded that the value of Ferolito's shares was approximately $1 billion. It ordered further proceedings to arrive at a more definitive computation.

Lessons learned

Whether or not a DLOM is warranted in fair value litigation varies depending on state laws, relevant legal precedent and the facts of the case at hand. This high-profile case spotlights a few factors to consider when addressing marketability. It also discusses a handful of other appraisal issues as it reconciles two widely divergent expert opinions to arrive at the most accurate and fair valuation. ◆

How financial restatements affect investor confidence

In recent years, many companies have restated their financial statements due to material accounting errors or fraud. How do these restatements affect investor confidence in a company's earnings reports? And for how long? A recent study provides some answers.

Negative effects linger

The results of the study, "Is the Decline in the Information Content of Earnings Following Restatements Short-Lived?", jointly conducted by professors at Singapore Management University and Boston College, can be useful in litigation involving financial statement fraud. They provide some ammunition for the argument that a restatement's impact on stock prices is longer-lived than previously thought.

Previous research had suggested that the negative effects of a restatement announcement were short-lived and bounced back after three quarters. But this study, based on a more recent and comprehensive sample of restatements, concluded that the impact is felt for closer to three years for material restatements (one quarter for other restatements).

Investor confidence matters

The study measures the impact of a restatement based on declines in the information content of earnings. "Information content" refers to the extent to which earnings announcements drive stock prices. The less confidence investors have in the accuracy of a company's earnings, the less impact that information will have on their investment decisions. To quantify information content, the authors used the earnings response coefficient (ERC). The ERC measures the relationship between stock-price fluctuations and the "unexpected portion" of — that is, new information in — companies' earnings announcements. It's important to note that stock price fluctuations must be analyzed in depth to determine whether there are any other possible causes of fluctuation.

For material restatements, the authors observed a pronounced post-restatement drop in the ERC that lasted 11 quarters on average. They attributed this result to a loss of financial reporting credibility. They also found that firms could mitigate the impact of restatements by taking prompt remedial actions to regain investors' trust. These actions include increasing accounting conservatism, removing the CEO and CFO, and replacing the external auditor or audit committee chair.

Understanding the impact

The study provides companies with valuable ammunition for managing risk, improving internal controls and identifying steps they can take to alleviate the impact of a material restatement. It also provides guidance for assessing economic damages caused by financial restatements and a party's efforts to mitigate those damages. In a litigation context, it's important to examine the *actual* impact of specific events on investor confidence and the subject company's stock prices. ◆

M&A fraud

Save your deal with comprehensive due diligence

Mergers and acquisitions (M&A) may seem like quick-and-simple ways to increase market share, compensate for operational weaknesses or acquire talented workers in scarce labor markets. Despite how great a deal may look on paper, some M&A transactions can be threatened by occupational fraud, which occurs when an employee deliberately misuses or misapplies an employer's resources or assets. Here's what business buyers and their advisors should know to help detect and prevent M&A fraud.

Haste makes waste

Fraud requires three elements: motive, opportunity and rationalization. When a company falls victim to occupational fraud, it can wreak havoc with financial results and yield erroneous value conclusions.

Unfortunately, M&A participants often don't investigate these elements, relying entirely on industry "rules of thumb" and gut instinct, especially in mature industries. Although rules of thumb can provide a reasonable basis for initial M&A discussions, they're rarely sufficient as the sole basis for a deal. One reason M&A deals may fall short of expectations is inaccurate assumptions resulting from occupational fraud, which a buyer may miss because of a lack of thorough due diligence.

Due diligence saves the day

Comprehensive due diligence refers to the systematic process of evaluating a proposed deal. It addresses financial, operational, technology and human resource issues. When due diligence is performed too hastily or its scope is too narrow, buyers are likely to overlook deal-threatening risk factors, such as poor internal controls and occupational fraud risks. Deciding how much to pay in M&A requires more than looking at financial statements and tax returns, performing site visits, and interviewing personnel, customers and suppliers. Buyers also need to investigate and reconcile problems and risk factors unearthed through acquisition due diligence.

When meeting with management of a potential M&A target or touring their facilities, proactive buyers look for circumstances ripe for theft or misstatement. During the process of seeking a buyer, owners and top managers may be distracted from fraud prevention and detection efforts as they scramble to put the deal together. In addition, layoffs precipitated by M&A may make it harder to implement strong internal control procedures, such as supervisory review and segregation of duties.

Fraud affects companies of all sizes, in all industries and geographic locations, and can involve everything from stealing inventory to misstating financial results for personal gain. As a result, value will be inflated because earnings or assets are overstated.

For example, an unscrupulous CFO might prematurely post unearned or fictitious sales at year end to boost his or her annual bonus. This scam also artificially inflates the company's purchase price — unless the buyer knows it's happening and adjusts the price accordingly.

The appraiser's role

Appraisers don't audit for fraud in the course of a typical business valuation assignment. Instead, they generally assume financial statements are free from error and material misstatement. Indeed, most valuation professionals aren't trained in forensic accounting. But some may inadvertently unearth gross anomalies when analyzing financial performance or touring company facilities. In any event, valuators will further delve into any transactions, balances or ratios that appear excessive or abnormal.

If you suspect fraud, discuss your concerns up front with your valuator. Some appraisal firms have in-house forensic accounting capabilities. Smaller firms can recommend a second expert to help unearth and quantify fraud's effect on value.

The best defense

Occupational fraud can become a deal-breaker for many investors, so it's important to unearth it, if possible. Clearly, the best defense against M&A fraud is thorough due diligence. Valuation experts aren't auditors, and can't be held responsible for finding fraud — but they know how to conduct due diligence and are well suited to helping acquiring companies, outside experts and attorneys evaluate M&A transactions. ◆

Valuations

Whether you are buying or selling, settling a legal dispute or securing financing, determining the value of your business for any reason involves many complicated factors. Since 1992, BCC Advisers has handled hundreds of valuations. We know the art and science of the valuation process and use the most resourceful methods to establish an objective fair market value for your business. Our consultants are individually accredited by one or more of the major appraisal organizations and use a comprehensive and thorough approach that minimizes intrusions on your day-to-day operations.

Litigation Support

BCC Advisers' valuation consultants have been called upon as experts in hundreds of litigation cases by both plaintiffs and defendants. Our valuation professionals can serve as witnesses and/or consultants for your case. Using our financial experience and insight, we handle multiple aspects of case preparation, leaving the attorney free to focus on the intricacies of the law. With our depth of business knowledge, the litigation team will have the added power needed for your success.

By serving as your source of fundamental strength, BCC Advisers helps you, in turn, find your own true strength. We cut through the gray areas of valuation and litigation support with concrete solutions that end in successful results. Results that our clients and their professional advisers can be proud of. When you require valuation or litigation support, please give us a call.

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