Third Quarter 2013

Valuation Insights

Inside

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In this edition of Valuation Insights we discuss how technology can be employed to improve tax department productivity. Corporate tax departments are shrinking for a variety of reasons; including consolidations, cost cutting measures, and acquisition synergies. This article discusses how new technologies coupled with workforce re-engineering can dramatically improve tax department productivity in the current environment.

In our Technical Notes section we discuss new accounting standard updates proposed by the Private Company Council related to the recognition and measurement of intangible assets in business combinations and goodwill impairment. The article also discusses the findings of a post-implementation review on the business combinations standard conducted by the Financial Accounting Foundation.

Our International Spotlight section discusses the rise in going-private transactions for companies based in China, reasons for this trend and the critical role of fairness opinions in these situations.

Finally, our Spotlight article discusses an updated guide, Valuation of Privately-Held Company Securities issued as Compensation, released by the AICPA. Commonly referred to as the "Cheap Stock Guide", this publication clarifies approaches and addresses accounting, disclosure and valuation considerations in connection with the valuation of stock-based compensation. The article highlights the most important updates to this guide.

In every issue you will find industry market multiples which are useful for benchmark valuation purposes. We hope that you will find this and future issues of this newsletter informative and reliable resources.

Read this issue to find out more.

Improving Tax Department Productivity through Technology and Workforce Re-engineering

A company's existence and value is predicated on growth. In the current economic environment, that means doing more with less, i.e. increasing productivity. Historically, productivity improvements have been achieved through the right-sizing of staff, consolidation of tasks, process re-engineering, and technological innovation. Productivity improvements ebb and flow depending on the economy in addition to how well a company has utilized productivity levers.

Re-engineering the Workforce – A Focus on Tax Departments

As with other corporate functions, the number of professionals in tax departments has shrunk dramatically through ongoing cost reduction initiatives. Management is left with questions, including:

- Has the reduction in personnel created net productivity gains?
- Are we achieving the same or a comparable level of diligence?
- Are we getting increased value out of the tax department?

Answers to the question of whether value has been created from staff reductions are often subjective. This is the case because objective data analysis (beyond traditional headcount measurements and budget reductions) is typically not available or measured.

This need for measurement and transparency also permeates throughout the organization. In a recent survey by Intel and Dell about the evolving workforce[1], six in ten employees want to be measured by the quality of work they deliver rather than time spent in the office.

To achieve more objective measurements, a tax department should consider organizing around discrete areas of service segmented into common skillsets. These can include incoming document management and data collection, return filing, advisory, tax bill processing and payments, technology support, etc. This structure allows more effective management of professionals (common goals, success metrics, etc.), and improved understanding of the cost of delivering specific services.

New Technologies That Dramatically Transform Productivity

Implementation of new technologies generally comes along with workforce re-engineering. Technology can provide a variety of returns on investment and some technologies in the market today can enable huge leaps in productivity. McKinsey Global Institute recently released a report[2] which states that three of the top four technology advances are mobile internet, automation of knowledge work, and cloud computing. Implementation of these technologies can vastly improve productivity for corporate tax departments.

Companies managing with fewer professionals in their tax departments are in need of transformational technologies to maintain the quality and diligence achieved with larger staffing. To better understand the needs of our property tax clients we conducted focus group sessions and received similar feedback that a new tax system is needed that possesses the following qualities:

- A solution the whole business can use instead of something that is dependent upon highly trained power users;
- The ability to standardize valuations across geographical boundaries to provide better insight on equity of property tax assessments;
- A flexible tool that automates laborious complex tasks; and,
- Provides quality jurisdictional rules and requirements for the entire property tax life cycle: returns, notices, appeals, and bill payments.

In response to these market needs, Duff & Phelps developed and recently released **TotalPropertyTax** – a property tax life cycle technology solution. This solution is delivered over a secure cloud computing platform thereby significantly improving the efficiency of a distributed workforce without impacting IT departments. TotalPropertyTax utilizes automation technologies which reduce the significant burden of extracting and validating vast amounts of data from unstructured sources (i.e. returns, tax bills, notices, websites, conversations, etc.). TotalPropertyTax's contemporary user interface is built to leverage advancements in the evolving tile design approach for mobile internet platforms.

TotalPropertyTax changes the game for tax departments by dramatically improving productivity through:

- The creation of paperless workflows that utilize advanced enterprise content management functionalities;
- Significantly reduced data transformation and load times through automating manual data manipulations;
- Cost reduction for third party consultants by providing rules and requirements in pivotal areas such as appeal filing; and
- Standardization of data in a more intuitive structure for purposes of benchmarking cost, values, and settlements.

In summary, corporate tax departments can continue to benefit from productivity gains despite significant declines in staffing by taking advantage of transformational technologies. Productivity gains can also be achieved by reorgaznizing teams around more discrete areas of function, setting performance measurements, and benchmarking their activities with industry peers.

For more information contact **Carl Hoemke**, Managing Director, at +1 469 547 3901 or visit www.totalpropertytax.com.

1. The Evolving Workforce - Report #2: The Workforce Perspective. July 25, 2012. http://intel.ly/15YEUFE
2. *McKinsey Global Insight: Disruptive technologies: Advances that will transform life, businesses, and the global economy. May 2013. http://bit.ly/12NqA0d.*

Technical Notes
Business Combinations, Intangibles and Goodwill

The Private Company Council ("PCC") has proposed relief from the heat of a summer of discontent for private companies by issuing proposed Accounting Standards Updates ("ASUs") aimed at simplifying the recognition and measurement of intangible assets in business combinations and goodwill impairment. Some highlights of the proposed accounting alternatives follow.

PCC Intangible Asset Proposal
Generally, private company financial statement users thought intangibles that are legally protected and that generate discrete cash flows are the most relevant in accounting for business combinations.

The Proposed ASU's accounting alternative includes the following:

- Intangibles would be limited to those arising from contractual rights with noncancelable terms, or that arise from other legal rights;
- Potential contractual renewals or cancel-ations are not considered in the valuation;
- Qualitative disclosure of the nature of the intangibles not recognized would be required;
- Disclosure of major contractual intangibles including their noncancelable term and basis for determining the value would also be required;

Examples of assets that may no longer be recognized:

- Customer lists;
- Noncontractual customer relationships;
- R&D that are not evidenced by noncancelable contractual terms;
- Unpatented technology;
- Databases;
- Contractual arrangements without noncancelable terms;
- Unregistered trade secrets, processes, or recipes.

PCC Goodwill Impairment Proposal
The PCC also received input from users of private company financial statements that they disregard goodwill and goodwill impairment losses in their analyses. Additional difficulties include:

- Less relevance as interim financial statements are not issued;
- Impairment calculation not well understood;
- Requires private companies to apply guidance on segment reporting to assess reporting units that is only applicable to public companies

The Proposed ASU's accounting alternative includes the following:

- If elected it would apply prospectively to all existing goodwill and to all new goodwill generated after the effective date;
- Goodwill would be amortized on a straight-line basis over the useful life of the primary asset of the acquired entity, not to exceed 10 years;
- Goodwill would only be tested for impairment when a triggering event occurs, not annually, and a qualitative assessment may be applied as part of the test;
- Impairment testing would be performed at the entity-wide level rather than the reporting unit level;
- Step two of the current impairment test (a hypothetical purchase price allocation) is eliminated and the impairment amount would be measured as the excess of the entity's carrying amount over its fair value and cannot exceed the carrying amount of goodwill;
- Amortization model is consistent with the IFRS for small-to-medium-sized entities.

Next Steps
The effective date and any changes to any provisions of the ASUs will be deliberated by the PCC.

It is noteworthy that the PCC considered that most users of the financial statements would have some level of access to management and could follow-up on disclosures, or request more detailed information on various assets. The PCC also acknowledges that certain users, such as regulators or lenders, may request that the entity not apply the accounting alternative even if it is otherwise eligible.

The PCC proposals are subject to due process, and need to be endorsed by FASB in their final form before FASB issues an ASU amending U.S. GAAP. Based on the feedback received in response to the PCC's proposals, FASB will separately consider whether it is appropriate to make the proposed accounting alternatives available to other entities.

FAF's 141R Post-Implementation Review
Separately, the Financial Accounting Foundation (FAF) has concluded its Post-Implementation Review ("PIR") on FASB Statement No. 141 (revised 2007).

FAF's report finds that, while overall Statement 141R addressed the practice issues associated with business combinations within its scope, certain issues were not fully resolved. In general, the principles and requirements are understandable and improved the relevance, representational faithfulness, and comparability of business combination information.

Ongoing difficulties included complexity and costs, especially in applying the requirements of Statement 157 (ASC Topic 820); measuring contingent consideration; identification as a business combination or asset purchase; and lack of transparency of valuation assumptions.

FASB will consider the comments received on the PCC proposals before taking forward the results of the PIR.

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International in Focus

The Role of Fairness Opinions in Going-Private Transactions in China

The Rise in China-Based Company Going-Private Transactions

Since 2011, over 50 China-based U.S.-listed companies have been involved in going-private transactions. Currently there are over 250 China-based companies traded on major U.S. exchanges, many of which may constitute the next wave of such companies to consider going-private transactions. We expect to see the wave of going-private deals continue in 2013 and 2014, given the influx of private equity firms and international banks into China and the Asia-Pacific region. There are also many Chinese banks, such as China Development Bank, that are willing to finance these buyouts as a policy to bring ownership "back home."

Why Are These Companies Going-Private?

The ongoing economic crisis, regulations imposed upon U.S.-listed companies, and recent accounting fraud allegations involving companies based in mainland China all combine to create an environment where a company may opt for a shift to private ownership or become the target of a going-private proposal from an insider group or consortium. The accounting scandals of some Chinese operating companies listed on U.S. exchanges have negatively impacted the market valuations of these companies since 2011, with many firms losing independent research coverage from reputable firms.

Companies with operations primarily based in China that trade on U.S. exchanges may be viewed as undervalued in the public markets and thus management teams, boards of directors, significant shareholders, and/or optimistic private equity firms alike may believe that they can maximize value through private ownership.

A buyer group may believe superior value creation can be realized by operating the company in a private environment where, among other considerations:

a) the regulatory, reporting, and shareholder communications costs associated with operating as a public company can be removed;

b) managing quarterly earnings performance is less of a priority, allowing management to focus on longer-term strategies without the worry of near-term stock price performance;

c) less disclosure regarding the company's performance and strategy may provide a stronger competitive advantage; or

d) the company can be taken private and then relisted on a local exchange at a higher valuation.

Ultimately, a going-private transaction may in fact maximize shareholder value. However, the path to going private involves certain processes, risks, and hurdles which must be navigated.

Why Do Special Committees of Boards of Directors Obtain Fairness Opinions?

With today's heightened awareness on corporate governance, boards of directors and special committees formed by boards are increasingly seeking independent fairness opinions in fulfillment of their fiduciary responsibilities when considering a corporate transaction.

Going-private and related party transactions, in particular, necessitate that boards of directors impose safeguards to protect shareholder interests, such as establishing a special committee consisting of directors who are completely independent of the acquiring group or the group's advisors and financing sources.

An independent fairness opinion helps to protect the board of directors, and in particular the special committee in the case of going-private transactions, and serves as an indication that the special committee and the board used reasonable business judgment in approving a transaction.

The Process

- Upon receiving a go-private proposal, a company's Board of Directors generally forms a Special Committee consisting of board members that are independent of the buyout group and the group's advisors.
- Although a board is not legally required to use a Special Committee to negotiate a related-party transaction, the Court of Chancery recently observed that the failure to use a Special Committee or other procedural safeguard "evidences the absence of fair dealing." Special Committees should have the ability to negotiate and the power to say "no."
- The Special Committee engages independent legal and financial advisors to provide advice in connection with the fairness of the transaction.
- A qualified and experienced financial advisor that assists in the evaluation of the deal terms and renders a fairness opinion is a critical element in the Special Committee deliberations, especially when a post-signing go-shop or a pre-signing market check is likely to prove futile or impractical due to a large majority block that would oppose another offer.
- Certain courts may consider fair price and fair process.
- A requirement of a "majority of the minority" voting in favor of the proposed transaction can also assist with both the fair price and fair dealing requirements. Not all going-privates have a majority of the minority requirement, but it is good protection for the shareholders and Special Committee.

A corporation's jurisdiction plays a key role when it comes to process and merger agreement terms.

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Spotlight
AICPA Publishes "Cheap Stock Guide"

In May 2013 the AICPA released the final edition of the guide, Valuation of Privately-Held Company Securities issued as Compensation, commonly referred to by valuation professionals as the "Cheap Stock Guide". The new edition encompasses valuation best practices developed over the previous decade – the original guide was published in April 2004. The working draft was released in 2011 and was the subject of thorough discussions by the investment community, regulatory agencies, and valuation and accounting firms. Guidelines apply to valuations in connection with FASB ASC 718 Compensation – Stock Compensation and FASB ASC 505-50 Equity Based Payments to Non-Employees.

The original publication established a foundation for valuing stock-based compensation – most notably, the introduction of equity allocation methods. The new guide focuses on clarifying approaches to reduce diversity in practice and providing practical guidance and illustrations for accounting, disclosure and valuation considerations. Key additions in the updated guide include:

- consideration for private and secondary market transactions – the guide indicates that these transactions should generally be considered unless evidence indicates a non-orderly transaction;
- guidance on the application of minority and marketability adjustments;
- updated guidance on allocation methodologies – illustrations of hybrid methods – combination of the Probability Weighted Expected Return Methodology and the Option Pricing Methodology; and
- treatment of debt and the impact of leverage — the guide discusses debt and equity fair value in highly leveraged entities.

The updated guide has an expansive Q&A section that provides practical illustrations and guidelines.

For more information contact **Louisa Galbo**, Managing Director, at +1 415 693 5312.

North American Industry Market Multiples

As of June 30, 2013

Industry	Market Value of Equity to Net Income		MVIC to EBIT		MVIC to EBITDA	
	U.S.	Canada	U.S.	Canada	U.S.	Canada
Energy	15.8	17.5	16.2	16.2	10.1	7.4
Energy Equipment & Services	19.8	15.3	15.6	12.3	8.9	6.6
Integrated Oil & Gas	8.9	—	7.5	—	5.5	—
Materials	16.0	11.5	13.2	11.3	9.3	6.0
Chemicals	16.9	10.3	13.6	12.8	9.7	8.4
Diversified Chemicals	17.4	—	13.2	—	10.0	—
Specialty Chemicals	18.7	—	14.2	—	10.3	—
Construction Materials	15.2	—	34.8	—	13.9	—
Metals & Mining	12.8	10.6	13.3	10.3	9.3	4.9
Paper & Forest Products	12.1	20.3	11.6	16.1	8.7	8.1
Industrials	17.0	13.6	12.9	13.8	9.7	9.8
Aerospace & Defense	15.1	10.9	12.7	14.9	9.2	12.4
Industrial Machinery	16.4	12.2	14.2	13.5	9.8	9.5
Commercial Services & Supplies	16.3	21.0	12.5	15.9	8.7	8.9
Road & Rail	17.9	13.5	13.3	13.8	8.2	7.4
Railroads	17.9	—	16.3	—	9.5	—
Consumer Discretionary	17.0	17.3	13.9	12.8	9.9	9.0
Auto Parts & Equipment	10.4	—	15.2	—	7.8	6.7
Automobile Manufacturers	10.3	—	17.0	—	14.0	—
Household Durables	12.9	—	15.2	—	10.8	—
Leisure Equipment & Products	16.4	18.4	12.2	13.1	9.2	11.0
Textiles, Apparel & Luxury Goods	14.9	—	12.2	—	10.5	—
Restaurants	26.5	19.9	17.8	12.4	10.9	6.3
Broadcasting	17.3	—	12.0	—	10.3	—
Cable & Satellite	16.0	14.9	17.0	12.0	9.1	7.2
Publishing	16.8	16.0	13.3	7.1	8.9	4.8
Multiline Retail	15.9	—	11.3	—	7.2	—

Industry	Market Value of Equity to Net Income		MVIC to EBIT		MVIC to EBITDA	
	U.S.	Canada	U.S.	Canada	U.S.	Canada
Consumer Staples	16.8	17.5	13.1	15.2	10.0	10.5
Beverages	20.5	20.5	18.8	16.9	12.6	9.9
Food Products	18.8	17.0	14.3	15.4	10.9	10.8
Household Products	18.6	—	13.4	—	10.3	—
Health Care	19.1	15.3	15.5	19.0	11.6	13.8
Health Care Equipment	20.4	—	15.1	—	11.7	—
Health Care Services	19.0	15.8	14.4	12.2	10.4	9.7
Biotechnology	16.1	—	16.7	—	16.5	15.6
Pharmaceuticals	14.0	—	13.2	24.5	10.1	14.2
Information Technology	19.7	21.1	17.5	22.4	13.3	12.6
Internet Software & Services	22.3	21.6	22.0	24.1	16.6	15.0
IT Services	19.5	17.8	13.9	15.9	10.3	10.9
Software	22.7	41.2	23.1	35.2	16.1	20.2
Technology Hardware & Equipment	17.5	16.8	16.4	16.3	11.9	10.0
Communications Equipment	17.3	12.1	21.1	14.1	13.8	9.7
Computers & Peripherals	19.8	—	19.7	—	13.9	—
Semiconductors	23.6	—	27.4	—	17.4	—
Telecommunication Services	19.3	12.2	18.8	12.1	7.5	6.7
Integrated Telecommunication Services	9.0	13.4	14.4	11.9	6.0	6.7
Wireless Telecommunication Services	20.7	—	21.4	—	7.9	—
Utilities	18.5	15.7	14.5	22.9	9.4	12.1
Electric Utilities	17.8	—	14.4	—	9.2	—
Gas Utilities	19.6	—	14.4	—	9.3	—

Industry	Market Value of Equity to Net Income		Market Value of Equity to Book Value	
	U.S.	Canada	U.S.	Canada
Financials	13.7	11.6	1.0	1.1
Commercial Banks	13.1	10.1	1.0	1.7
Investment Banking and Brokerage	19.7	5.5	1.1	0.6
Insurance	13.8	13.4	1.0	1.4

An industry must have a minimum of 5 company participants to be calculated. For all reported multiples in the U.S. and Canada, the average number of companies in the calculation sample was 98 (U.S.), and 31 (Canada); the median number of companies in the calculation sample was 51 (U.S.), and 12 (Canada). Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Research Insight and Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest fiscal year. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

European Industry Market Multiples
As of June 30, 2013

Industry	Market Value of Equity to Net Income	MVIC to EBIT	MVIC to EBITDA
Energy	10.9	12.0	8.1
Energy Equipment & Services	11.9	12.9	8.7
Integrated Oil & Gas	10.0	6.1	4.1
Materials	14.4	12.8	7.5
Chemicals	17.3	13.7	8.8
Diversified Chemicals	—	—	—
Specialty Chemicals	19.0	14.7	10.5
Construction Materials	20.8	16.9	8.7
Metals & Mining	12.8	10.6	6.4
Paper & Forest Products	10.2	12.7	7.0
Industrials	14.7	13.3	9.4
Aerospace & Defense	14.7	14.2	9.2
Industrial Machinery	14.1	12.6	9.3
Commercial Services & Supplies	15.9	13.2	8.2
Road & Rail	10.8	11.8	6.2
Railroads	—	—	—
Consumer Discretionary	15.6	13.7	9.4
Auto Parts & Equipment	11.0	9.5	6.1
Automobile Manufacturers	7.9	14.6	9.6
Household Durables	14.5	12.7	8.6
Leisure Equipment & Products	11.7	12.9	8.5
Textiles, Apparel & Luxury Goods	21.2	15.2	11.1
Restaurants	19.4	14.9	11.3
Broadcasting	15.6	12.0	10.2
Cable & Satellite	—	19.8	9.6
Publishing	13.5	12.1	8.8
Multiline Retail	—	—	8.4

Industry	Market Value of Equity to Net Income	MVIC to EBIT	MVIC to EBITDA
Consumer Staples	16.2	15.2	10.2
Beverages	20.5	17.3	12.7
Food Products	14.6	14.6	9.9
Household Products	—	15.5	10.2
Health Care	20.2	16.2	11.6
Health Care Equipment	16.6	13.3	10.2
Health Care Services	11.2	11.6	8.6
Biotechnology	28.5	21.6	17.5
Pharmaceuticals	20.0	14.3	11.3
Information Technology	18.1	13.9	10.5
Internet Software & Services	32.1	19.8	15.0
IT Services	15.1	12.2	8.9
Software	20.6	16.0	11.4
Technology Hardware & Equipment	17.0	13.6	9.9
Communications Equipment	15.9	13.6	10.3
Computers & Peripherals	16.8	14.9	11.4
Semiconductors	20.1	19.3	12.3
Telecommunication Services	12.8	11.6	6.5
Integrated Telecommunication Services	12.7	11.1	5.8
Wireless Telecommunication Services	7.3	9.4	6.5
Utilities	14.1	15.6	8.9
Electric Utilities	15.0	14.0	8.3
Gas Utilities	—	—	—

Industry	Market Value of Equity to Net Income	Market Value of Equity to Book Value
Financials	11.8	1.0
Commercial Banks	10.9	0.6
Investment Banking and Brokerage	16.6	1.1
Insurance	10.0	1.1

An industry must have a minimum of five company participants to be calculated. For all reported multiples in Europe, the average number of companies in the calculation sample was 87 and the median number of companies in the calculation sample was 37. Sample set includes publicly-traded companies (private companies are not included). Source: Data derived from Standard & Poor's Research Insight and Capital IQ databases. Reported multiples are median ratios (excluding negatives). MVIC = Market Value of Invested Capital = Market Value of Equity plus Book Value of Debt. EBIT = Earnings Before Interest and Taxes for latest fiscal year. EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization for latest 12 months.

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