

After Economic Storms, Companies Finding a Silver Lining

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BUY-SELL AGREEMENTS

for Closely Held and
Family Business Owners

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How to Know Your Agreement Will Work
Without Triggering It



BUY-SELL AGREEMENTS

for Closely Held and Family Business Owners

Z. Christopher Mercer, ASA, CFA, ABAR

Foreword by Tom Deans, Ph.D.
Author of *Every Family's Business*

BUY-SELL AGREEMENTS

for Closely Held and Family Business Owners

by **Z. Christopher Mercer, ASA, CFA, ABAR**

Buy-sell agreements are among the most common yet least understood business agreements, and many are destined to fail or fall short of owner's expectations and needs. Many, in fact, are ticking time bombs, just waiting for a trigger event to explode.

This book is designed to provide business advisors and owners a roadmap for developing or improving their buy-sell agreements.

ABOUT THE AUTHOR

Chris Mercer is a nationally known business valuation expert, writer, and speaker. As a recognized leader in his profession, Chris has occupied front-row seats in courtrooms and boardrooms concerning buy-sell agreement disputes and planning. These vantage points provide a unique perspective of how buy-sell agreements should work for business owners by properly defining the valuation process and other critical elements of buy-sell agreement functionality.

**“This book is the business owner’s
self-defense manual”**

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Value Added™ contains articles from Mercer Capital's Valuation, Financial Reporting, and Financial Institutions service groups. Mercer Capital provides a broad range of business valuation and investment banking services, including financial reporting and tax valuations, M&A advisory, fairness and solvency opinions, ESOP and ERISA services, and litigation support. **For more information, visit www.mercercapital.com.**

After Economic Storm, Companies Finding a Silver Lining

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HOW HAS THE ECONOMIC DOWNTURN AFFECTED YOU?

The economic downturn had an adverse effect on each of the client companies surveyed.

- » A service-based company reported that business activity declined by about 25% in 2009, year-over-year. The company's president noted that "the customer pie shrank and creativity with pricing and service offerings became the norm. Almost every existing pricing contract that we had in place from 2008 was subject to customer requested re-negotiation."
- » An apparel manufacturer "had customers cancel orders and re-evaluate their inventory positions" in the fall of 2008. However, in July 2009, orders picked up in response to low inventory positions and the company's "production levels today are the highest they have been in several years."
- » A professional services firm noted that in late-2008 "long time clients began downsizing their projects." Further, in early-2009 business was down 14%, but for the full year business was down 12% year-over-year, indicating that the pace of activity in the latter half of 2009 was improving.
- » A distributor of chemical products experienced a year-over-year revenue decline of approximately 30% in 2009.
- » A building component manufacturer reported that their business has generally tracked the homebuilding industry throughout the economic downturn. While they operated at around 40-50% of capacity in 2009, this level was still ahead of the industry which operated at about 35%. Business activity picked up in the first half of 2010 and the company is operating near 60% of capacity.
- » An asset manager stated that "the stock market slide that began at the end of 2007 and accelerated in the fall of 2008 greatly eroded our fee income."
- » A public finance and municipal law attorney indicated that the financial markets collapsed in many respects in the fall of 2008, and demand for his work as bond counsel suffered as a result. However, by the end of 2009, financing prospects had improved substantially, but the deals that were getting done were plain-vanilla, basic financing transactions with virtually no complicating elements. By the spring of 2010, financing lines of credit remained difficult, but was improving. Current financing difficulties are enhanced by the general slowdown in economic activity and the fact that many banks remain undercapitalized, particularly in the face of uncertain regulation (e.g., future capital requirements).

Related Services

- » An electrical contractor, involved in commercial, industrial, and institutional electrical contracting, indicated that “with the economic downturn, the company’s backlog at the end of 2009 was down by about 20% compared to 2008.”
- » Several survey respondents indicated that their employee headcount was reduced as a result of the economic downturn. A service-based company stated that they “did not let anyone go or have anything close to a layoff, but those employees that left for further education or spousal relocation, etc. were not replaced.” Similarly, a building component manufacturer said that they “had a few layoffs, but mostly managed to cut the workforce through attrition.”
- » A hardware and home improvement products distributor stated that the “housing market downturn has had a negative effect on revenues. Less building means less hardware, lumber, etc... However, it has also made us better managers of the business and has reduced costs by increasing productivity and controlling expenses.”
- » One distributor indicated that, as a result of the economic downturn, it had stopped 401k matching and virtually all employees stopped contributing to their retirement savings. Further, overall employee morale was low due to reductions in compensation and benefits in tandem with the prospect of a slow recovery.

WHAT DO YOU FORESEE IN THE NEXT 18 MONTHS?

Virtually every company surveyed expects modest growth, but growth nonetheless, over the next 18 months.

- » A manufacturer of aluminum extrusion equipment company expects “a recovery of sorts in the U.S.” and reports that their “industry is seeing a pick up in orders.”
- » A domestic and international shipping company said they anticipate their business will experience a “gradual, small single digit growth” rate in 2010.
- » A shoe manufacturer expects the 2010 fall season “to be better than last year, but there is a sentiment that the economy is still pretty soft and once inventory levels improve and even stagnate a little, we expect 2011 to be flat. 2010 should be a good year, though.”
- » One company expects “overall growth for the economy will slowly increase over the next year and a half. Unemployment will remain fairly constant and will take more than the 18 month time frame to get back down to more normal levels. Housing and overall building and building improvements will trend upward with the overall growth of the economy. Consumer spending will increase slightly but will be held back by the unemployment rate and lack of access to credit.”

Mercer Capital is a full-service business valuation and transaction advisory firm. We provide the following services:

- » Corporate Valuation
- » Litigation Support
- » Financial Reporting Valuation
- » Tax Compliance Valuation
- » Employee Stock Ownership Plan Valuation

Our client companies range from public to private, from smaller companies to large multi-nationals in a broad range of industries, as well as numerous governmental agencies.

The professionals of Mercer Capital also provide transaction advisory services and can guide you through the uncharted waters of selling your business, acquiring another business or division, mergers, valuations, fairness opinions, and other transaction advisory needs.

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For many surviving companies, the silver lining of such adversity is that management is now better able to efficiently allocate labor and capital, operations are running leaner, employee productivity is generally higher, and market share is there for the taking.

- » A professional services firm expects “slower percentage growth than we experienced historically.”
- » A company that distributes sealants and concrete restoration products expects “gradual, but inconsistent improvement” with the inconsistency relating to “some cities recovering faster than others.”
- » A brick manufacturer expects “slow, continued improvement over the next 18 months” and they believe “the 3rd quarter of 2011 will be the earliest (their) industry will resume some level of normalcy.”
- » An asset manager said that “for the economy, we see very slow growth hampered by high unemployment.”

As indicated by the comments above, most companies are expecting a modest recovery from a micro- and/or macro-economic perspective; however, slow growth rates are anticipated by most companies for the balance of 2010 and into 2011. Survey respondents expect neither a V-shaped recovery, nor a material near-term drop in unemployment.

- » Only one client company noted expectations for uneven growth rates across different geographic regions; however, it appears that such region-specific growth rates are relatively common at geographically-diverse companies which are affected by housing markets and/or construction activity.
- » A provider of aluminum extrusion systems noted that its business in “China seems to be rebounding nicely with some ordering and quoting activity.”
- » One professional services firm stated that they are putting “more focus on existing clients, differentiating (themselves) by

exceeding expectations of outcomes.” The firm aims to “grow and retain (a) better percentage of existing clients, understanding that new business is more difficult, more expensive and slower to achieve.”

- » In the same vein, an asset-manager indicated that in the wake of a decline in asset prices “clients tend to assume that all (asset) managers are doing as badly as the client’s manager and stay put,” reducing the prospect for obtaining new clients.

CONCLUSION

A Duke University / *CFO Magazine* Global Business Outlook Survey asked 1,102 CFOs from a wide range of companies about their economic expectations. In the survey, CFOs of U.S. based companies indicated that 59% of domestic companies do not expect employment to return to pre-recession levels until 2012 or later. Further, one-fourth of domestic companies violated or almost violated a covenant on their credit lines. The top macroeconomic concerns for U.S. businesses are (1) consumer demand and (2) the federal government’s agenda/policies, while the top internal (firm-specific) concern is maintaining profit margins.

Another client provided the following commentary, which summarizes several key aspects of the economic downturn and how companies are operating in its wake:

“We can hope for “change”, but more likely, we better figure out how to accomplish change. ... This recession or economic correction has brought to light a lot of ingredients that proved to be false indicators of true economic growth. ... We suspect that most Americans hereafter will buy more cautiously, pursue less credit, and the financial industry will likely go back to asking for more collateral. ... As a company, we must remain hungry,

competitive and willing to be flexible with the conditions as they change. As we look to our industry, we can see a thinning of the herd has occurred.”

Yet another client stated that their industry may not return to “some level of normalcy” until the latter half of 2011, but then went on to explain they are not quite sure what “normalcy” will look like. It seems that many companies operating within significantly downsized industries are attempting to understand what the “new normal” will be in the wake of the economic downturn. In the future, normal growth rates in some industries may fall well below historical trends, whereas other industries may soon pick up where they left off prior to the economic downturn.

The economic downturn adversely affected companies in virtually all industries. Shrinking demand in tandem with excess leverage caused

many businesses to close their doors. For many surviving companies, the silver lining of such adversity is that management is now better able to efficiently allocate labor and capital, operations are running leaner, employee productivity is generally higher, and market share is there for the taking.

At Mercer Capital, we interact with a large number of client companies operating in many industries. We understand that the economic downturn has not only affected certain industries in unique ways, but also companies within each industry have unique perspectives of the downturn and (cross your fingers) near-term recovery.

What has not changed is the need for sound and reasonable valuation analyses from a trusted advisor. When the need for valuation services arises, please call us at 901.685.2120 to discuss the matter in confidence.

Uncertainty Surrounds Future of the Estate Tax

In a special report recently published by *Trust & Estates* titled, “Estate Planning & Taxation: Scratching Your Head Over 2010 Estate Plans,”¹ four leading tax attorneys were asked to respond to questions about the future of the estate tax.

The attorneys, Charles A. Redd, of Sonnenschein Nath & Rosenthal LLP., David A. Handler of Kirkland & Ellis, David R. Hodgman of Schiff Hardin LLP, and Joshua S. Rubenstein of Katten Muchin Rosenman LLP, were asked questions related to client receptivity (to planning in a time of uncertainty), problems experienced while dealing in this environment, the possibility of retroactive changes to the estate tax law, and the prospects for change after 2010.

The panel was divided on most questions. But some of the panelists were bold in their predictions, nevertheless. Charles A. (Clary) Redd, a long-time friend of Mercer Capital, said:

“I boldly predict that retroactive reinstatement of the federal estate tax and GST tax bill will not occur.”

But no one knows for sure. Now that we are past the mid-term elections, hopefully there will be some clarity soon. However, the varied comments were, in their own way, helpful as a tool for thinking about the issues.

For more on issues surrounding the future of the estate tax, please see page 7.

¹ “Estate Planning & Taxation: Scratching Your Head Over 2010 Estate Plans,” *Trust & Estates*, August 2010, pp. 14-19.

Managing Complicated Multi-Tiered Entity Valuation Engagements in the Gift & Estate Tax Environment

For many high net worth individuals and family offices, modern estate planning and investment practices have resulted in complex ownership structures ... this article is offered with the intention of informing referral sources and their clients about the processes that lead to credible and timely valuation reports.

by **Jean E. Harris, CFA**

High net worth business owners, and in particular baby boomers, who have created substantial wealth are becoming increasingly concerned with the orderly transfer of their assets. Planning for effective wealth transfer in the prevailing uncertain tax environment has complicated and confused many wealthy individuals and their counsel. As of the writing of this piece in late 2010, there is no estate tax and the gift tax rate is 35%. However, without out new legislation, in 2011 the estate and gift tax rates both return to 55% and are applicable to transfers greater than \$1 million.

Much of today's accumulated wealth has been generated by legacy operating businesses and investments, and, through prior gifting programs and other estate tax planning activities, has been transferred into investment vehicle entities or reallocated into other assets.

For many high net worth individuals and family offices, modern estate planning and investment practices have resulted in complex ownership structures, typically involving multi-tiered entity organizations and businesses with complicated ownership structures and governance.

Mercer Capital has been performing complicated tax engagements for decades. This article is offered with the intention of informing referral sources and their clients about the processes that lead to credible and timely valuation reports.

These processes make for smoother engagements and minimize the surprise and/or resistance to furnishing the information necessary to mitigate potential IRS scrutiny. With evidence of increasing audit risk in many regions and with rising appraisal requirements, high net worth individuals and their advisors need a thorough, proactive understanding of how to contribute to a high quality, well-informed appraisal work product.

DEFINING THE ENGAGEMENT AND COLLECTING INFORMATION

Defining the valuation project is an important step in every engagement process, but when multiple or tiered entities are involved it becomes critical.

It is generally insufficient to define a complicated engagement by limited reference to the top tier entity in a multi-tiered organizational structure. The appraiser needs a complete understanding of the scope of the valuation project in order to design the deliverable work product and to plan the underlying due diligence and analytical framework.

Working with the appraiser, the referral source needs to define the problem in such a way that the appraiser understands if he/she needs to perform an appraisal at each level of a tiered structure or if certain

entities and their underlying net assets can be valued using a collapsed or consolidated analytical framework. In many cases there is a little of both.

Simplifying assumptions and appropriate asset bundling often lead to better, more comprehensible and forthright opinions. Multi-tiered minority interest appraisals can be particularly prone to error via inappropriate or cumulative discounting and/or other valuation treatments that may fail to retain the qualities of fair market value.

During the initial discussion of the engagement the appraiser will usually request certain descriptive and financial information (such as governing documents, recent audits, compilations and/or tax returns) to determine the scope of analysis needed to render a credible appraisal for the master, top-tier entity and the underlying entities and assets.

Full and complete disclosure of all requested information, as well as other information believed pertinent to the appraisal, will aid the appraiser in preventing double-counting or otherwise missing assets all together.

In some instances the requested information, in tandem with client or referral communications, will inform the appraiser and allow him/her to deliver a work product that can save the client time and money. For example, if 10 similar dry cleaning entities need to be appraised, it may be possible to write a single report narrative explaining the big picture and furnish ten sets of valuation worksheets demonstrating the specific valuation of each entity.

Once the business appraiser and the client's advisor have agreed on the specifics of the engagement, the appraiser will craft an engagement letter specifying the key elements of the appraisal assignment. The engagement letter will provide a descriptive project overview, the qualifications of the appraiser and set forth the timetable and fee agreement. Upon receipt of the signed engagement letter and retainer the information collection process begins in earnest.

Often a comprehensive request for information will accompany the engagement letter. The initial information request generally includes each entity's historical financial statements, as well as detailed operating and structural information about the businesses and the markets in which they operate.

Businesses with an organized set of financial and operating information are easier to analyze and, therefore, easier to value than those that do

not keep good records. Fee structures are generally inversely correlated to the amount, availability, and organization of underlying business information. The more complete and timely the business information is, the better the opportunity for fee efficiencies in the appraisal process. Additionally, information quality almost always promotes a more predictable outcome with the IRS and with other stakeholders.

REVIEWING THE DRAFT APPRAISAL WORK PRODUCT

Multi-tiered entity structures are typically years, if not generations, in the making. For their creators and insiders, the entity organization is second nature. To an outside appraiser, it can seem a complicated web of assets and liabilities lacking a cohesive or comprehensible structure. As discussed previously, starting with a plan and identifying a simplified (albeit sufficiently comprehensive) reporting framework and analysis are the first steps to a successful project. However, clients and their advisors must not take the upfront effort for granted by failing to adequately review the draft report and analysis.

No parties are more equipped in multi-tiered or otherwise complicated entity structures to review for completeness and factual accuracy than the creators and insiders of the subject entity(s). Appraisers value assets and cash flow streams and they do their best to capture the intricacies of legal entity structure. However, clients of valuations involving complicated, multi-tiered entities owe themselves a thorough inquisition of the draft report with numerous questions in mind:

- » Does the valuation analysis appear to reflect the economic nature and value of the core assets at each respective entity level?
- » Are the respective collections of assets and liabilities at each entity tier adequately described and captured in one form or another?
- » Do insiders and advisors recognize their entity creation within the outside appraiser's report document?
- » Does the project reflect a reasonable top-down or bottom-up sequencing that facilitates quality reviewing and easy of comprehension to lay reviewers? Could you teach an outsider what this collection of entities and the underlying assets are by way of the valuation report?

Please see **Complicated Engagements**

The Time to Gift is Now

As we approach the end of 2010, the window for maximizing wealth transfers may be closing.

by Timothy R. Lee, ASA and Wendy S. Ingalls, CPA/ABV, CBA, ASA

It seemed unthinkable – would congress let 2009 pass without addressing the scheduled lapse of the estate tax? Well, they did, granting 2010 decedents and their families the gold lining of a tax free estate. In the dusk of 2010 we now face the scheduled sunset of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”). Absent fourth quarter congressional action, gift and estate tax provisions are set to return to pre-2001 levels. In keeping with the theme of old things becoming new again (like egregious gift and estate tax rates), we repeat last year’s call from the rooftops: Gift Now!

As we approach the end of 2010 the window for maximizing wealth transfers is arguably closing from multiple perspectives. First, the valuations of many businesses and assets are down due to the plight of the economy. History suggests that even the worst economic shocks will not keep us down forever. Second, higher and reinstated taxes, in tandem with potential new prohibitions against certain valuation treatments, will not be conducive to efficient wealth transfer.

If you believe that Congress will extend prevailing tax provisions, thereby keeping the gift tax rate at an historical low of 35%, then no urgency is required. If, however, you believe that Congress will allow EGTRRA its scheduled sunset, in which case the highest marginal rate will return to its previous level of 55% on January 1, 2011, then NOW is the time to gift. The present economic and political climate provides individuals an opportunity to gift at a favorable rate, at a time when value is depressed, providing the ability to gift more for less.

Although low investment asset values are far from ideal, you can mitigate the pain by taking advantage of the opportunity transfer wealth at tax rates unlikely to be seen again for some time, if ever. Assuming an ownership interest with a fair market value of \$5.0 million in the fall of 2010, a top gift tax rate of 35% and a joint unified credit of \$2.0 million, a married couple would pay gift tax of \$1,050,000 on the transfer of the interest.

For the sake of example, we will assume that Congress takes no action pertaining to the gift tax by the end of 2010 and the gift tax rate reverts to pre-2001 levels. In Fall 2011, given an increase in fair market value of 10%, a married couple’s tax liability would nearly double, as shown in Figure One.

Figure One	
Assumed Value of Investment Portfolio in 2010	\$5,000,000
- Unified Credit	2,000,000
= Taxable Gift	\$3,000,000
Gift Taxes Paid Out of Other Assets on Taxable Gifts @ 35.0%	\$1,050,000
Approximate Value of Same Portfolio in 2011	\$5,500,000
- Unified Credit	2,000,000
= Taxable Gift	\$3,500,000
Gift Taxes Paid Out of Other Assets on Taxable Gifts @ 55.0%	\$1,925,000
Difference in Gift Taxes Paid on Gift of Same Assets	(\$875,000)

Using the same assumptions, with no growth in the investment portfolio (an unfortunate possibility), the tax savings is still significant, as shown in Figure Two.

The current depressed prices, combined with the looming gift tax increases present a unique opportunity to make gifts. If you would like to discuss this illustration with regard to a particular matter, please contact us. It is not too late to take advantage of this, but it might be on January 1.



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Figure Two	
Assumed Value of Investment Portfolio in 2010	\$5,000,000
- Unified Credit	2,000,000
= Taxable Gift	\$3,000,000
Gift Taxes Paid Out of Other Assets on Taxable Gifts @ 35.0%	\$1,050,000
Approximate Value of Same Portfolio in 2011	\$5,000,000
- Unified Credit	2,000,000
= Taxable Gift	\$3,000,000
Gift Taxes Paid Out of Other Assets on Taxable Gifts @ 55.0%	\$1,650,000
Difference in Gift Taxes Paid on Gift of Same Assets	(\$600,000)

Continued from **Complicated Engagements**

- » If there has been any collapsing or combining of entities for valuation purposes, do the groupings makes sense in terms of the nature of the assets and their operational character? Do the valuation methods applied seem reasonable and consistent from one asset grouping to another?
- » Are cross-entity assets and liabilities reconciled or adjusted? One entity's asset may be another entity's liabilities. As such, do the valuation treatments and results reconcile from one entity to the next?
- » If valuation discounts are used, are they applied in defensible fashion and at the appropriate place(s) with the tiered entity structure?
- » Does the report say what it does and does it do what it says? (Yogi Berra, where are you?)

Engagements involving complicated entity and operational structures are not easily shoe-horned into an appraiser's typical reporting formats and presentation. Unique entity and asset attributes will suggest unique solutions and presentation standards.

Despite the tailored requirements of advanced appraisal work, the final report document and the underlying valuation analysis must be both

comprehensive and concise. In some cases there are no easy shortcuts, thus a certain amount of analytical intricacy is required. Such situations require adept and skillful execution and detailed explanation in the report.

CONCLUSION

Mercer Capital has significant experience dealing with large, complex, multi-tiered entity engagements.

Our experience ranges from the closely held domain of the family office to large, sophisticated corporate enterprises and investment funds. We pride ourselves in differentiating our services and approach through careful pre-engagement planning in order to provide enhanced fee and timing expectations. We are committed to delivering value in a fashion that improves the planning and decision making processes of our clients and their advisors. To discuss in confidence any engagement requiring Mercer Capital's customized valuation solutions, please contact any of our senior valuation professionals.



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Valuation of Convertible Preferred Stock in Recent TARP Exchanges

In October 2008, the U.S. Treasury birthed the Capital Purchase Program (“CPP”) under the Troubled Asset Relief Program (“TARP”) to stabilize financial institutions by means of capital injections. In order to facilitate additional equity investment, the Treasury began participating in exchanges of CPP preferred stock for other securities. This article provides an overview of one such security, the mandatorily convertible preferred stock, and examines the valuation issues surrounding CPP preferred stock exchange.

by **Jay D. Wilson, Jr., CFA** and **Francis O. Lynch**

In October 2008, the U.S. Treasury birthed the Capital Purchase Program (“CPP”) under the Troubled Asset Relief Program (“TARP”) to stabilize financial institutions by means of capital injections. Through the CPP, the federal government invested \$205 billion into 707 banks and thrifts in exchange for preferred stock and stock warrants. By June 2010, 76 institutions repaid an aggregate \$146.9 billion to the Treasury.¹

In spite of the high percentage of repayment, 91 other banks and thrifts missed the preferred dividend owed to the Treasury in May.² As an investor, the Treasury has faced situations where it must evaluate options that could improve the financial stability of some of these 91 banks to best generate a return on its investments. To attract additional capital from other investors, a distressed bank may need to eliminate the Treasury’s (and others’) preferred claim. This relationship creates a prisoner’s dilemma where the preferred investors, including the Treasury, desire others to inject fresh capital into the bank, but capital may only be provided if the distressed bank no longer has preferred obligations senior to new capital.

In order to facilitate additional equity investment (and hopefully realize some value from its CPP investment in institutions where the institution’s ability to continue as a going concern is in doubt), the Treasury began participating in exchanges of CPP preferred stock for other securities.

One such security exchanged is mandatorily convertible preferred stock (“MCP”). Through this exchange transaction, the Treasury provides distressed banks an enhanced ability to raise new capital by exchanging outstanding CPP preferred stock held by the Treasury for MCP (and an amended warrant). The Treasury has permitted exchange of CPP preferred stock for MCP in at least three banks prior to June of 2010.³

MANDATORILY CONVERTIBLE PREFERRED STOCK

The terms of the MCP are substantially similar to the terms of the preferred shares exchanged. The differences lie in the ability for the MCP to convert to shares of common stock in the underlying bank. The MCP converts into common stock in three different ways⁴:

- » The holder (U.S. Treasury) has the option to convert at a preset conversion rate at any time.
- » The issuer can compel conversion at the preset conversion rate if certain preset capital raising conditions are satisfied.
- » If the MCP does not convert prior to the 7th anniversary of the exchange, the MCP will mandatorily convert into shares of common stock on that date at a conversion rate such that MCP

Related Services

Conditions	Stock Price	Security Holder's (Treasury's) Perspective
Satisfied	Increase	Benefits from greater value of conversion feature and decreased likelihood of default
Satisfied	Decrease	Risk of the Company compelling conversion at a value unfavorable to the holder (i.e. the holder would benefit more by holding non-convertible preferred stock)
Not Satisfied	Increase	Benefits from greater value of conversion feature, but likelihood of default would still be high without recapitalization
Not Satisfied	Decrease	Decreased value in the conversion feature in addition to the increased default risk

holders receive full liquidation preference (\$1,000 per share plus accrued dividends).

VALUATION ISSUES

Analysts typically value convertible bonds as the sum of two elements: (a) a base bond with no conversion feature plus (b) a long call option on shares of stock representing the additional gains a bondholder could receive. New dynamics to this equation must be considered when valuing MCP due to the distressed nature of the issuer, the potential ability for the issuer to compel conversion, and dilutive effects from the creation of new common shares.

The diagram displays four general scenarios of conditions to conversion (such as the institution raising additional capital) and price movements and the benefits or risks associated with each scenario to an MCP holder (the Treasury).

As shown above, the value of the MCP depends on the holder's views of which scenarios are more likely to occur. The value of the MCP can be determined through three different perspectives:

If a market participant knows the conditions to compel conversion will not be satisfied, the security could parallel a typical convertible bond: base preferred stock (with no conversion rights) plus a long call option on potential gains in excess of face value.

On the other hand, if a market participant knows the conditions to compel conversion will not be satisfied, the issuer might fail and the holder could have nothing. If the holder believed this would happen he would convert as soon as possible and extreme dilution would follow.

The Financial Institutions Group of Mercer Capital provides a broad range of valuation, investment banking, and industry expertise to assist banks, thrifts, mortgage banks, money managers, brokers/dealers, insurance companies, and REITS meet their financial objectives.

Our banking clients range from new bank charters to multi-billion dollar (assets) bank holding companies. We have worked for numerous governmental agencies, including the IRS, the FDIC, the SBA, the U.S. Attorney General's Office, and the Attorney General of the State of Tennessee. Our work has been reviewed and accepted by the major agencies of the federal government, including the SEC, the FDIC, the Federal Reserve, the Office of Thrift Supervision, and the OCC. Our work has also been reviewed by the largest accounting firms in the nation in connection with transactions involving their clients.

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If a market participant knows the conditions to compel conversion will be satisfied, the security has characteristics that resemble a slightly different bundle of securities: base preferred stock plus a long call option minus a short put option on the bank's common stock. Minimal weight might be placed on the ability for the issuer to compel conversion (the short put option) because the MCP holder would generally anticipate that stock price increases would follow the capital raise.

In order to comply with financial reporting requirements under GAAP, the MCP investment and amended warrant are required to be recorded at fair value as defined in ASC 820⁵. When determining fair value, the aforementioned three perspectives must be analyzed to develop indications of value and ultimately weighted according to the general likelihood of condition satisfaction and price increase. This is not an

easy task given the uncertainty and distressed state of the banks that typically exchange CPP outstanding preferred stock for MCP.

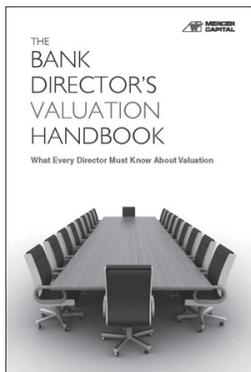
Mercer Capital has measured fair value for this specific type of MCP along with many other complex securities. This experience, coupled with Mercer Capital's knowledge and longstanding expertise of financial services clients, qualifies us to render credible, independent opinions of value regarding most intangible or financial assets carried at fair value. If we can be of assistance as your bank completes its financial reporting, please do not hesitate to contact a member of Mercer Capital's Financial Institutions Team at 901.685.2120.

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ENDNOTES

- ¹ "Troubled Asset Relief Program Monthly 105(a) Report, May 2010." <http://bit.ly/boaORI>.
- ² Ibid.
- ³ Ibid.
- ⁴ Capital Assistance Program Mandatorily Convertible Preferred Stock and Warrants Terms. <http://bit.ly/3w2IFY>.
- ⁵ Accounting Standards Codification 820, formerly SFAS 157.

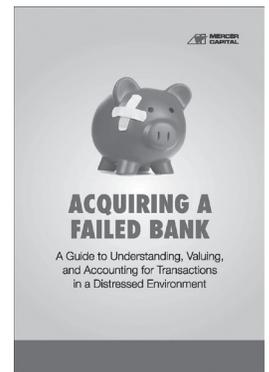


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HEINZ PROMOTED TO SENIOR VICE PRESIDENT

Mercer Capital is pleased to announce that **Nicholas J. Heinz, ASA**, has been promoted to the position of Senior Vice President. Nick joined Mercer Capital in 2000 and is a senior member of Mercer Capital's investment banking and corporate valuation division.

"In his decade with the firm, Nick has been consistently fervent in his efforts to make the greatest possible contribution to Mercer Capital," said Mercer Capital president **Matthew R. Crow, ASA, CFA**. "We are fortunate to be able to position him to contribute at a more senior level."

ADDITIONS TO OUR STAFF

Mercer Capital is pleased to announce the addition of **Mr. Alex M. Barry** and **Ms. Whitney L. Faust** to our professional staff as a Financial Analysts.

Alex holds a Bachelor of Arts in Economics from Vanderbilt University. Whitney is a graduate of Rhodes College, holding a Bachelor of Arts in International Business.

In their capacity as Financial Analysts at Mercer Capital, Alex and Whitney will provide business valuation and financial consulting services to a broad range of companies and financial institutions across the nation.

HAMNER EARNS THE RIGHT TO USE THE CHARTERED FINANCIAL ANALYST DESIGNATION

Brooks K. Hamner has earned the right to use the Chartered Financial Analyst (CFA) designation from the CFA Institute. This designation is recognized around the world as the premier designation in the finance profession. Brooks is a senior financial analyst at Mercer Capital.

Earning the CFA designation requires four years of qualifying work experience and the successful completion of three six-hour examinations. A successful candidate must also adhere to the CFA Institute *Code of Ethics and Standards of Professional Conduct*.

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