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MERCER CAPITAL'S LATEST THINKING

Business Value Before & After a Recession

by Z. Christopher Mercer, ASA, CFA

FEATURED ARTICLES

ALSO INCLUDED

VOLUME 21, NO. 3 :: 2009

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MERCER CAPITAL

HEADQUARTERS :: 5860 Ridgeway Center Parkway, Suite 400, Memphis, Tennessee 38120 » 901.685.2120 (P) » 901.685.2199 (F)

LOUISVILLE OFFICE :: 455 South 4th Street, Suite 690, Louisville, Kentucky 40202 » 502.585.6340 (P) » 502.585.6345 (F)

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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.

Business Value Before & After a Recession

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

According to economists, the country is emerging from the worst economic downturn since the Great Depression. Yet, according to those same economists, the road to recovery will be long and arduous. The stock market is still down, and unemployment is still extremely high. Investor expectations and risk perceptions have dashed the valuations of the publicly traded companies which serve as primary benchmarks in the valuation of closely held companies. Sales, as well as earnings, at your company are likely down, and, yes, the value of your company is likely down.

We have had the unenviable task of delivering the news of down valuations to many clients in this harsh business cycle. In some cases, value was down even when our clients had actually increased sales and earnings. The worlds of business and value have been less than optimal since the onset of the current recession. For our many financial institution clients, the current downturn is more of the same trend that started with the sub-prime mortgage crisis more than two years ago.

Some clients and many appraisers have experienced their first recession. Those of us more seasoned, if you will, have experienced other recessions and we remember the pain. Living through a recession is a trying thing, and often takes the fun out of business. For many, it feels like the recession has not yet ended. During down times, we have all witnessed examples of business owners, managers, and employees becoming demoralized or even paralyzed by the fear of an unknown future. This tendency to focus inward out of fear and to adopt a pack mentality (everyone else is doing it or not doing it) is what many term "recessionary thinking."

How do we respond to recessionary thinking? An antidote is "recessionary action." As consultant Dr. Jim Harris, author of *Corporate Excellence: How to Maximize Long-Term Productivity and Profits*, says, "Fast and good is better than slow and perfect." We should all be taking action and working on our businesses as the recession ebbs.

Specifically, we should be focused on key aspects of our businesses such as sales, cash flow, customer service, systems, and capital spending.

- **Sales.** If competitors have reduced their sales force, it is time to be more outbound and focused on gaining market share. Work hard to maintain, as well as create, relationships with prospects and clients.

- **Cash flow**. Managing cash flow is vital in a recession. Below are three areas on which to focus.

  - **Accounts receivable**. During slow times, customers tend to slow down payments, so it is important to stay on top of receivables. I learned a useful trick by trial and error as a young consultant working for a pool supply distribution company. When customers slowed down payments in the 1983-1984 recession, the company consistently called the customers' accounts payable clerks (not top management) and politely asked to be moved up in their payment queues. The acceleration in cash flow experienced kept the company alive while many others in that business did not survive.

    Always keep in mind that managing accounts receivable can be tricky. Remember you are making decisions that will be long remembered by those customers whose businesses persevere through this cycle.

- › **Expenses**. Review "habitual" expenses and determine if they are justified. Preserving profitability helps to preserve value in a down economy. You cannot save your way to success; however, you can eliminate some bad habits and preserve or enhance margins.

- › **Inventories**. It is critical to focus on inventories when sales are declining. Cash flow can be managed by reducing inventories, thereby maintaining reasonable turns on lower sales. Get rid of slow-moving or stale inventory, even if margins suffer. It is better to have the cash than to experience deterioration on the shelves.

- » **Customer service**. When business is slow, there is a natural tendency for people to slow down production/projects in order to appear busy. This yields a deterioration in customer service. Do not let this happen. Now is the time to focus intently on timely and quality customer care.

- » **Systems**. Every business operates with a variety of systems in sales, operations, manufacturing, distribution, and delivery. Take time, after providing excellent customer service, to evaluate and improve critical systems. At virtually every company, there are at least one or two systems that everyone knows need to be overhauled or tweaked.

- » **Capital spending**. In the December 2008 issue of the *Harvard Business Review*, Robert S. Kaplan and David P. Norton suggested that senior executives take the time to differentiate between capital expenditures and strategic expenditures, or "Stratex." So called Stratex items were deemed the last resort when reducing investment. Short term fixes for underperforming capital hardware and systems could be the most expensive solutions if they are made in lieu of incremental investments in positive change. We should be cautious not to emerge from the current recession with yesterday's solutions.

While it is always a good idea to focus on these areas, it is critical now. "Recessionary action" helps maintain momentum when fighting this economic headwind. It also creates the opportunity to potentially gain critical ground on competitors.

A question you must ask yourself is where will our businesses be and what will the value be when full recovery comes? And what is the value of your business now? Despite the natural aversion we all have to facing the realities of bad economic news, it is vital to understand the value of your business now. You may have a buy-sell agreement whose terms need to be adjusted. It may be time to review life insurance coverage for your buy-sell agreement or for estate planning. It may be a good time to put the incentive stock options that were promised long ago or to sell stock to key employees. With tax law changes currently being contemplated, it may be an ideal time to make gifts of stock.

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RELATED SERVICES

Valuations are a critical element of successful tax planning strategies. Consequently, objective third-party valuation opinions are vital. Mercer Capital has over twenty years of experience providing objective valuations for tax compliance.

Mercer Capital's opinions of value are well-reasoned and well-documented which provide critical support for any potential challenge, although the consequence of our thorough, well-reasoned and well-documented work has resulted, in the overwhelming majority of the time, in quiet acceptance by the IRS and state and local taxing authorities.

Mercer Capital provides the following services related to tax compliance:

- » Closely held stock valuations for family wealth planning and estate tax compliance
- » Business valuations for corporate restructurings and related tax planning
- » Executive stock option valuations for tax planning
- » Business & intangible asset valuations in connection with Subchapter S tax status
- » Intellectual property valuations
- » Restricted stock valuations for family wealth planning and estate tax compliance
- » Valuation of covenants not to compete
- » 409a compliance

Contacts

Z. Christopher Mercer, CFA, ASA
mercerc@mercercapital.com » 901.685.2120

Timothy R. Lee, ASA
leet@mercercapital.com » 901.322.9740

Nicholas J. Heinz
heinzn@mercercapital.com » 901.322.9788

Wendy S. Ingalls, CPA/ABV, CBA, ASA
ingallsw@mercercapital.com » 901.322.9716

Jean E. Harris, CFA
harrisj@mercercapital.com » 901.322.9761

Megan M. Bartels
bartelsm@mercercapital.com » 901.322.9759

B. Tyler Beckman
beckmant@mercercapital.com » 901.322.9754

Francis O. Lynch
lynchf@mercercapital.com » 901.322.

Focus on Financial Institutions:

Selecting an Appraiser and Understanding the Valuation Process

SELECTING AN APPRAISER

Regardless of the reason your bank needs a valuation, one of the most critical decisions is the selection of the appraiser. When selecting an appraiser, defining the valuation assignment properly is vitally important, and you should consider a variety of factors, including experience, training, background, longevity in business, independence, and reputation. While fees are important to everyone, they should not be a primary consideration in your choice. The following list includes what we consider to be the primary questions to ask each appraiser prior to selection.

» Do you perform business valuations on a full-time basis?

» How many valuations has your firm performed over its history? How many annually? How many full-time appraisers are on your staff?

» Do you have a dedicated group of appraisers focused on the valuation of financial institutions? If so, how many appraisers are primarily focused on financial institutions?

» How many valuations of financial institutions has your firm performed? How many annually? How many valuation assignments has your firm performed that are similar to the assignment requested by the bank (ESOPs, estate tax, transaction advisory, statutory fair value, financial statement reporting, etc.)?

» Are your senior professionals members of professional organizations such as the Business Valuation discipline of the ASA, the CFA Institute, or other recognized professional groups?

» Have your professionals taught any valuation courses, spoken on valuation topics or published any articles or books on business valuation topics for financial institutions? If so, can you provide a list?

» Will you provide a list of references?

» Do you have access to the more prominent data sources such as Standard & Poor's, SNL Financial, *American Banker*, Ibbotson, or resources of similar quality?

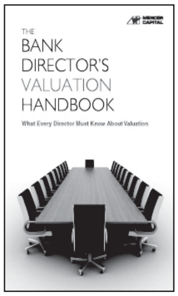
» What is your litigation experience with financial institutions?

» Have you performed valuations of financial institutions for any governmental agencies (the Internal Revenue Service, the Department of Labor, etc.)?

UNDERSTANDING THE VALUATION PROCESS

While the steps for each assignment may vary depending upon the scope of work provided (appraisal, limited appraisal, or calculations), the appraisal assignment typically progresses in the following steps.

1. **Define the Valuation Assignment** – According to the ASA BV Standards, the appraiser should identify and define each of the following: 1) the business, business ownership interest, or security to be valued; 2) the effective date of the appraisal; 3) the standard of value; and, 4) the purpose and intended use of the valuation. Additionally, the nature and scope of work (appraisal, limited appraisal, or calculations) should also be defined. Generally, this part of the process includes discussion between a number of parties, including the appraiser, the client, and the client's tax and legal counsel, when appropriate.



One important component not to overlook is specifying the effective date of the appraisal, which appraisers typically refer to this date as the "as of" date of the valuation. Once this date is established, appraisers rely upon information that is (or was) reasonably available to conduct due diligence for the valuation assignment. For banks, appraisals are typically based upon the most recent quarterly financial statements that would have been available prior to the valuation date. For example, an appraisal with an effective date of July 15, 2008 would rely primarily upon June 30, 2008 financial data. In certain situations, a valuation is needed at an effective date in the distant past, which requires the appraiser to exercise judgment as to what would have been available at that particular time. This occurs often in valuations to be used for estate tax or litigation purposes.

2. **Gather Information** – At this point in the process, the appraiser gathers and analyzes the information required to perform a valuation appropriate to the scope of work. While valuing financial institutions has some advantages in the information gathering process due to the amount of publicly available financial information, an appraiser typically sends an information request to the client for additional items that are not publicly available, such as board reports, asset/liability management reports, shareholder agreements, lists of graded loans and loan loss reserve adequacy calculations, securities portfolio inventories, and other documentation deemed necessary for the specific engagement.

3. **Conduct On-Site Visit** – The on-site visit provides the analyst with an opportunity to develop an understanding of how the subject financial institution operates and to integrate many sources of information about a particular bank into a logical framework. Specific objectives of the visit include reviewing details of documents previously provided, developing an opinion of the local economy based on observation, developing an impression of management and their ability to achieve anticipated

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RELATED SERVICES

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.

Our valuation services are organized as follows:

- Goodwill Impairment Services
- Capital Raising Consulting Services
- Fairness Opinions
- Minority Shareholder Transactions
- Mergers, Acquisitions, & Corporate Reorganizations
- Financial Statement Reporting Compliance
- Litigation Support and Expert Testimony
- Core Deposit and Other Intangible Asset Appraisals
- Employee Stock Ownership Plans
- Tax Compliance
- Strategic Analysis of Alternatives to Enhance Shareholder Value
- Financial Advisor to Independent Board Committees

Contacts

Andrew K. Gibbs, CFA, CPA/ABV
gibbsa@mercercapital.com » 901.322.9726

Jay D. Wilson, CFA
wilsonj@mercercapital.com » 901.322.9725

Laura J. Hoffmeister, CFA
hoffmeisterl@mercercapital.com » 901.322.9764

Madeleine C. Gilman
gilmanm@mercercapital.com » 901.322.9753

Laura O. Matthews
matthewsl@mercercapital.com » 901.322.9746

Contingent Consideration

5 Things that CFOs and Controllers Should Know

by **Travis W. Harms, CFA, CPA/ABV**

With many acquirers spending 2009 on the sidelines, the new accounting treatment for contingent consideration arrangements under SFAS 141R remains largely untested. When markets thaw, however, we expect that acquirers will be anxious to make up for lost time, and a resumption of deal activity will spark new conversations with auditors regarding the appropriate treatment of earnouts and other forms of contingent consideration.

As an expression of our faith in the future of the economy, we offer a few cautionary notes regarding the accounting for contingent consideration.

1. **Auditors will expect detailed, supportable analysis regarding fair value**. It may seem that the fair value of a contingent consideration agreement is unknowable; after all, if you and the seller could have reached an agreement on price, you would have. However, the FASB believes that fair value can be reasonably estimated. From the standpoint of your auditors, the midpoint of the potential payout range is not sufficient. Be prepared to offer reasoned probability assessments regarding the range of likely outcomes.

2. **Fair value measurement for contingent consideration liabilities can be complex**. Estimating the fair value of contingent consideration liabilities requires a different set of tools than that ordinarily applied to measure the fair value of assets. Expected value techniques for cash flow estimation and discount rate development will be much more prevalent when determining the amount that would be paid to a market participant to assume the contingent consideration liability. This is a subtle, but significant shift from determining the amount that would be received from a market participant in exchange for an asset.

3. **There is no one-size-fits-all valuation model.** Every contingent consideration agreement is unique. With the wide array of potential performance metrics, measurement periods, performance hurdles, and payment terms, the valuation model will have to be tailored to each particular liability.

4. **Contingent consideration liabilities require ongoing monitoring and assessment.** Veterans of fair value accounting for goodwill and other intangible assets have grown accustomed to annual impairment testing under SFAS 142 and 144. While there is no impairment testing for contingent consideration liabilities, remeasurement is required at every balance sheet date. So, for public companies, the ongoing monitoring and assessment requirements for contingent consideration can actually be more onerous than for goodwill or other intangible assets.

5. **A robust acquisition date fair value estimate is the best defense against future earnings volatility.** The most common concern we hear from clients is the potential for future earnings volatility stemming from the requirement to remeasure the contingent consideration liability at each balance sheet date. An increase in fair value will result in a charge to earnings, while a decrease in fair value will trigger a credit to the P&L. While changes to fair value are inevitable, a well-reasoned estimate of fair value on the front end is the best tool for mitigating undesirable earnings volatility.

Travis W. Harms, CFA, CPA/ABV
harmst@mercercapital.com

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Interestingly, in the course of assessing value for many clients during this downturn, we have found ourselves challenging clients to envision and project how they are likely to emerge and recover when the economy turns positive again. In so doing, many business executives and senior managers are able to anticipate the needs and challenges of providing for a future based on a range of expectations, both operationally and financially. The most basic tenet of business valuation translates future profitability to a present value today. Admittedly, no spreadsheet exercise in and of itself is going to translate to future performance. However, in our experience, envisioning and projecting how you are likely to emerge from the recession can serve as a road map for identifying critical choices to act upon.

Many business owners intellectually understand this a good time to pursue family and business ownership plans, but many, as alluded above, are simply emotionally paralyzed and willing to cocoon for a better day. The problem with inaction is you compound the problems of today by not capitalizing on the opportunities. When the full recovery comes, where will you be, and what will be the value of your business?

Z. Christopher Mercer, ASA, CFA
mercerc@mercercapital.com

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Selecting an Appraiser and Understanding the Valuation Process

operating results, and identifying factors or trends that can be expected to influence future performance. From time to time, the appraiser may conduct the interview by telephone if circumstances warrant it.

4. **Draft the Report** – At this point, the ball is in the appraiser's court and the appraiser works to prepare the valuation analysis and draft of the valuation report.

5. **Issue the Draft Report to Client and Client Review** – The client receives a copy of the draft report and is given the opportunity to review and question the appraiser's analysis. As a user of a valuation report, providing an adequate review to evaluate the appraiser's assumptions and confirm the accuracy of factual statements is important.

6. **Finalize the Valuation Report** – Once the client, their advisors, and any other interested parties have had a chance to review the report and pose any questions or comments regarding the draft to the appraiser, the appraiser issues the final report.

While the steps outlined above are subject to change depending upon the circumstances of each valuation assignment and the specific appraisal firm engaged, they provide a general outline of the steps involved and what to expect should you retain a valuation professional to perform a valuation.

MERCER CAPITAL
HIGHLIGHTS

Mercer Capital's professionals are actively engaged in thought leadership through various speaking engagements, published articles, and more.

CREDENTIALS EARNED

Laura J. Hoffmeister, B. Patrick Lynch, and **Jay D. Wilson, Jr.** have all 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.

Hoffmeister, Lynch, and Wilson are senior financial analysts at Mercer Capital.

Earning the CFA designation requires a dedicated effort over a minimum of three years to pass three six-hour examinations. A successful candidate must also have at least four years of professional experience in the investment decision-making process and adhere to the CFA Institute *Code of Ethics and Standards of Professional Conduct.*

MERCER CAPITAL ANALYSTS ACHIEVE 100% PASS RATE ON CFA EXAMS

Mercer Capital analysts have once again excelled in this year's Chartered Financial Analyst exam, achieving a 100% pass rate for the professional designation exams, which are sponsored by the CFA Institute.

Jay D. Wilson passed the Level 3 exam, while **Sujan Rajbhandary** passed the Level 2 exam, and **Madeleine C. Gilman** passed the Level 1 exam.

The CFA charter is a globally recognized standard of expertise in investment analysis and portfolio management. Over 104,000 candidates around the world sat for the three levels of the charter tests this year. The overall pass rate for all candidates this year was just 45 percent.

"Every CFA charterholder recognizes what a grueling process it is to pass each of the three levels of tests," noted Mercer Capital president, **Matt Crow, ASA, CFA.** "Having all of our analysts pass their respective levels at the same time is remarkable, and demonstrative of the sheer volume of analytical talent we have on hand."

Upcoming Speeches

January 7, 2010
"Subsequent Events: Known or Knowable"
Valuation, Forensic Accounting, & Litigation Services Conferences
Ft. Lauderdale, Florida
Z. Christopher Mercer, ASA, CFA

January 8, 2010
"Subsequent Events"
Teleconference sponsored by BV Resources
Z. Christopher Mercer, ASA, CFA

February 1, 2010
"Important Valuation Issues for Banks in 2010"
Acquire or Be Acquired Conference
Phoenix, Arizona
Andrew K. Gibbs, CFA, CPA/ABV

April 17, 2010
"Buy-Sell Agreements"
ACTEC Regional Meeting
Knoxville, Tennessee
Z. Christopher Mercer, ASA, CFA

May 5-7, 2010
"Subsequent Events"
AICPA/AAML 2010 National Divorce Conference
Las Vegas, Nevada
Z. Christopher Mercer, ASA, CFA

To book a speaker for your next meeting, contact Barbara Walters Price at 901.685.2120 or priceb@mercercapital.com.

Patton Retires After 25 Years, Crow Named President of Mercer Capital

PATTON

CROW

After a 25-year career with the firm, **Kenneth W. Patton** retired as President of Mercer Capital, effective August 14, 2009. A former co-owner, Ken was instrumental in helping to build Mercer Capital into one of the largest and most successful independent business valuation firms in the nation. His retirement, and the subsequent leadership transition, had been planned for as part of the firm's strategic plan and leadership transition process which began with the installation of the firm's employee stock ownership plan in 2006.

Chris Mercer remains as CEO. **Matthew R. Crow**, formerly a senior vice president who has been with the firm for 15 years, assumes the office of President. Matt noted that he is "humbled that the Board and the professionals of Mercer Capital have placed their confidence in me. Stepping into Ken's shoes will not be easy. However, in planning for this transition, Ken made certain that the foundations of Mercer Capital were strong. We are all excited about the future and, as always, ready to serve the needs of our clients."

"Ken has been an important part of our growth as a firm. I will miss having his counsel on a daily basis. However, Ken will be working with us on a project-by-project basis when his expertise is needed and I am happy to maintain that relationship for the firm and our clients," said Chris Mercer.

Ken Patton remarked, "My wife, Grace, and I are thrilled to begin this new chapter in our lives. It has been a fun and challenging 25 years. I am so grateful to the professionals at Mercer Capital, our clients, referral sources, and friends for helping to make my career at Mercer Capital so fulfilling."

Recent Transaction

Community Trust Financial Corporation

Ruston, Louisiana

Advisor to Community Trust Financial Corporation in its acquisition of First Louisiana Bancshares, Inc.

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For a list of completed transactions, see www.mercercapital.com

Mercer Capital has over 25 years of experience assisting financial institutions undertake significant corporate transactions. Whether considering an acquisition, a sale, or simply planning for future growth, Mercer Capital has the experience required to help financial institutions accomplish their financial objectives.

Mercer Capital can help financial institutions by:

- » Evaluating Acquisition Opportunities
- » Executing a Sale
- » Issuing Fairness Opinions
- » Analyzing Branch Acquisitions
- » Delivering Board Presentations
- » Providing Customized Financial Analyses

Call **Andy Gibbs**, **Chris Mercer,** or **Jay Wilson** at 901.685.2120 to discuss your transaction advisory needs in confidence.

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5860 Ridgeway Center Parkway, Suite 400

Memphis, Tennessee 38120

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