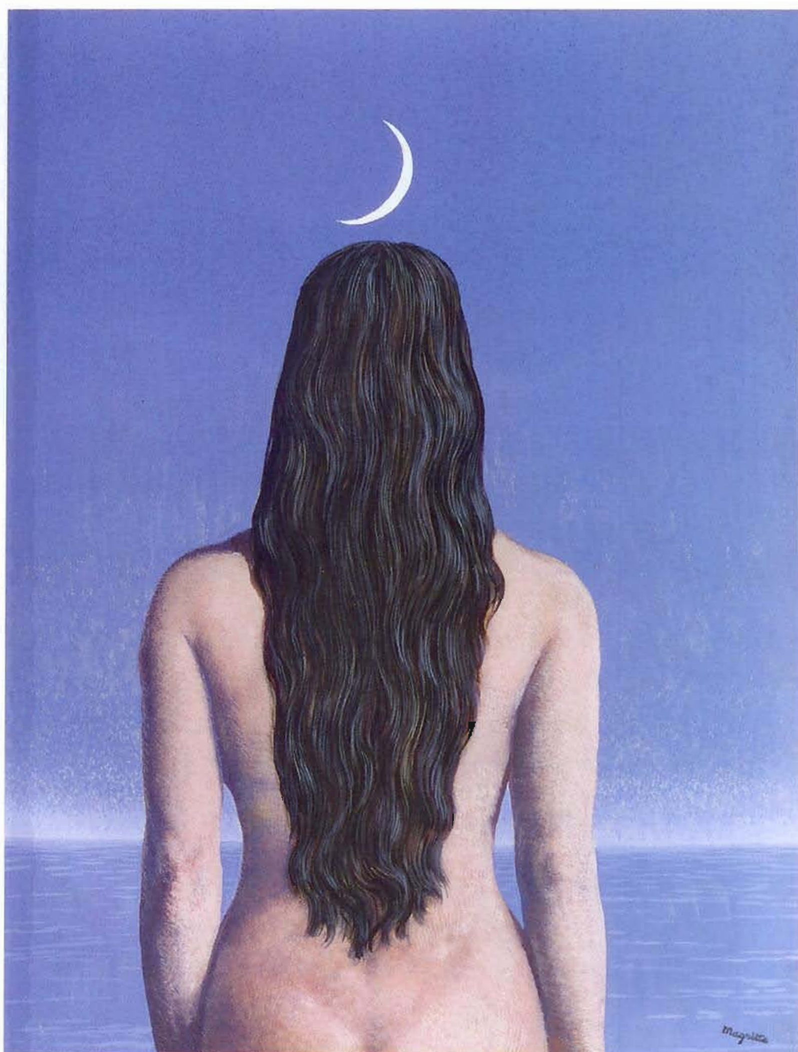
MARCH 2010

A Penton Media Publication

$35.00

Trusts & Estates

The Journal of Wealth Management for Estate-Planning Professionals—Since 1904



Perspective— René Magritte's *"La robe du soir"* sold for a little more than $1.5 million at a recent Christie's auction in London, p. 4.

BRIEFING

10/ **Tax Law Update • Swiss Secrecy—Surprise Holding**

FEATURES

18/ **Virtual Partners**
Bust the myths that keep colleagues from working out of their homes
By Emily J. Kuo & Louis S. Harrison

21/ **The Fully Discretionary Ascertainable Standard**
It's a terrific strategy that sets up both tax and creditor protections
By Anthony F. Vitiello & Daniel B. Kessler

26/ **Successor Trustee Liability**
What to know before accepting a fiduciary appointment
By Irina S. Shea & Kevin Matz

30/ **Excess Corporate Cash**
Consider steep discounts of the value of dollars minority investors hold
By Gregory A. Barber

COMMITTEE REPORT
RETIREMENT BENEFITS

36/ **Roth IRA Conversions, Nontraditionally**
Here's how to handle unusual assets
By Michael J. Jones

43/ **Cash Balance Plans**
Ideal stock/bond proportions to build retirement portfolios quickly
Stephen Lippman & Gregory D. Singer

By Gregory A. Barber

Excess Corporate Cash

For estate and gift tax purposes, think about significantly discounting the value of a dollar when it's held indirectly by a minority investor

Logic dictates that valuation experts assume that cash is worth its face value in majority interest or control scenarios. And that assumption makes sense: In such instances, control of a company provides access to and control over the assets, including cash.

But experts fail to see that in minority interest valuations for both private and public companies, a different perspective is required—particularly when excess cash is held within a private operating business.

There are many reasons why excess cash in minority interest valuations should be evaluated carefully and valued separately from a company's operations. Imagine, for example, that a company has entrenched management and poor investment opportunities; clearly, in such a case, we should significantly discount excess cash. Even if a company is doing well, it often makes sense to discount excess cash in minority interests.

On the other hand, cash may be valued at a premium to face value if management is responsive to investor requirements, management's interests are aligned with investors, and a company has unique investment opportunities.

Valuation experts who fail to distinguish between cash in majority interest or control situations versus minority situations risk overvaluing a company. Of course, that, in turn, can lead to a client overpaying gift and estate taxes. This failure to distinguish between cash in majority interest situations versus minority interest situations is even more important these days as many companies are holding more cash reserves hoping to weather the uncertainties of the current economic environment. (Google, for example, has about 60 percent of its total book assets in cash.)

Excess cash can be worth significantly less than its face value to minority investors—as much as a 65 percent to 70 percent less.

Here's why.

The Basics

The first step in most primary going-concern valuation methods (such as the discounted cash flow analysis, public comparable method, and transaction approach) is to determine a company's "enterprise value." Enterprise value is derived by adding the value of the debt and equity together, then subtracting the total cash and equivalents balance. To determine the equity value, a valuation analyst subtracts the fair value of the debt from the enterprise value and adds the total cash and equivalents balance.

For example, assume the enterprise value of a company is $10 million, its debt is $2 million and its cash is $5 million. The equity value is $13 million ($10 million enterprise value, less $2 million debt, plus $5 million cash).

Determining a company's enterprise value assumes that cash is worth its face value.[1] But there's significant evidence showing that—in minority or non-controlling valuations—cash is not worth its face value.

For starters, valuation experts for minority or non-controlling interests often fail to consider the "agency problem." Conflict can arise when people (the agents) entrusted to look after the interests of others (the principals) use the authority or power that the principals gave to them (directly or indirectly) for their own benefit. This problem is pervasive and exists in almost every organization whether it's a business, club, religious entity or governmental agency. The conflict

Gregory A. Barber is the managing director of Barber Analytics, LLC in San Francisco

plays out, for example, in corporations in which corporate managers have the ability to operate in their own self-interest rather than in the best interest of the firm and investors. Corporate managerial abuse can manifest in executives consuming corporate resources such as perquisites and salary, and in making poor investments. (Of course, inexperience or incompetence also can lead to poor investments.)

An entrenched management team with control of the company, takeover defenses or a weak board can exacerbate the agency problem.

Organizations try to solve the agency problem by providing incentives for good behavior (stock options in corporations) and punishments for bad behavior (dismissal by the board of directors). Also, state lawmakers recognizing the agency problem often provide a mechanism for minority shareholders in private companies to assert some degree of influence to counteract mismanagement and breaches of fiduciary duty by controlling shareholders, board members and corporate officers. Hence, there are prudent investor rules and fiduciary standards of care that management must follow.

Of course, the agency problem is not new. Many decades ago, famed economist Adam Smith noted: "The directors of such companies. . . being the managers of other people's money rather than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which [they would] watch over their own." And Smith concluded: "Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."[2]

To a large extent then, the valuation of excess cash balances depends on how well corporate managers manage resources for their investors, administer corporate management interests versus investor interests, and whether investors can replace poor or unscrupulous managers.

The Research

There are dozens of academic papers that examine factors that impact the valuation of cash holdings in corporate entities. In their 2005 research paper, Amy Dittmar, from the Ross School of Business at the University of Michigan, and Jan Mahrt-Smith, of the Rotman School of Management at the University of Toronto,[3] specifically examined how corporate governance impacts the valuation of cash holdings of public companies. Their study used large institutional holdings (more than 5 percent) as a proxy for corporate oversight and the number of anti-takeover provisions in a company's articles of incorporation as a measure of management entrenchment. The proxy for good corporate governance was 5 percent or more institutional investors and few, if any, anti-takeover provisions. Dittmar and Mahrt-Smith found that managerial entrenchment and a lack of shareholder oversight had a significant impact on the valuation of cash reserves: Firms with poor corporate governance dissipated cash reserves more quickly and invested in projects and companies with poor accounting returns. Poorly governed firms spent their cash at a rate almost twice as fast as well-governed firms.[4] Moreover, the market value of excess cash is reduced up to half when the firms are poorly governed.[5] On the other hand, they also found that firms that were well-governed had excess resources "fenced in;" their excess cash was valued 75 percent greater than the poorly governed firms.[6]

Of course, this leads us to ask how "poorly governed" public companies, under the study's criteria, compare to private companies. All other things being equal, a private minority investor is in a worse

Managerial entrenchment and a lack of shareholder oversight have a significant impact on the valuation of cash reserves.

position to deal with an underperforming and/or self-serving management team than a minority investor in a public company. Often in a private company, the majority shareholder controls the company and the board. Absent a breach of fiduciary duty, the management team or directors are very difficult to remove. Furthermore, there is no public spotlight or oversight by the Securities and Exchange Commission of management's activities to keep a private company's management team behavior aligned with shareholders. Although circumstances vary widely among private companies, minority investors in private companies are far more likely to find themselves involved with "poorly governed" companies.

Other studies[7] have found that company managers of companies with excess cash invest in projects that have a negative net present value (NPV). Negative NPV occurs when a project or investment opportunity is not expected to generate returns sufficient for its level of risk. For example, a company that doesn't generate profits but does have millions in revenue is likely to engage in a negative NPV project or investment. Managers may leap into these risky ventures because even negative NPV projects can provide revenue growth for the firm, allowing managers to justify salary increases and perquisites and satisfying personal needs for power, prestige and promotion.[8]

One study[9] found firm managers invest in projects using discount rates of 3.5 percent to 4.0 percent below those that investors would use. A lower discount rate makes an investment opportunity look more attractive and therefore more likely to be selected. But what this setup means is that investors who are looking for returns of, say, 15 percent on company investments, will get only 11 percent. Investors then discount the value of the company shares so that they achieve the return they require. This adjustment leads to the discounting of excess cash balances.

Not all of these studies' authors conclude, however, that cash should be valued at less than its face value for minority interests. When firms have good growth options (such as high return investment projects), cash is valued at a premium to face value. In their 2005 working paper, Lee Foster Pinkowitz and Rohan Williamson, associate professors at Georgetown University's McDonough School of Business, reported that the market valued $1.00 of cash at firms with low leverage, several investment opportunities and good growth options as high as $1.76.[10] This premium for cash is likely because such firms are in unique positions to earn returns above their cost of capital.

Size and Pricing

In October 2009, we examined two groups of companies to:

(1) provide insight into the corporate characteristics that lead to discounted cash balances; and

(2) furnish some estimate of how minority investors value excess cash.

For Part 1 of our study, we screened for companies that have an equity market capitalization and total debt less than their cash holdings. We then examined the selected companies' attributes to determine the factors that lead to discounts of the cash value.

In Part 2, we examined the share price impact of surprise special dividend announcements on companies that held excess cash. Once we determined the impact on the share price, we compared the change in share price to the amount of the dividend. For example, if the share price went up $0.40 for every $1.00 of dividend, we could deduce that prior to the dividend announcement, the market had valued the cash at $0.60 per dollar, or a 40 percent discount.

Cash as an asset is difficult to value because the public exchanges, such as the NYSE and NASDAQ, only directly value equity, derivatives and debt. It's unknown how the market perceives the value of individual assets of a going-concern business, absent a transaction of some sort in the asset. For the first part of our analysis, we concluded that if the equity capitalization and total debt of a business with ongoing operations is less than its cash balance, the cash balance must be valued at much less than its face value.

Our screening selected U.S. non-financial public companies with an enterprise value less than zero. That means

the cash balance needed to be greater than the equity market capitalization and total debt. We also eliminated companies with more than $1 million of debt so as to focus on conservatively financed companies. In addition, in an attempt to eliminate a lack of liquidity that can cause equity pricing discounts, we also eliminated companies with equity valuations of less than $5 million.

Our initial screen produced 34 companies.

As an additional step, we eliminated companies with no operations, which were either "blank check" companies or firms that were selling off assets and winding down operations.

We were left with 27 publicly traded companies.

The size of companies in our sample tended to be quite small, with an average equity capitalization of just over $40 million. The majority, 17, were companies in the technology or biotechnology industries; 10 were from other industries such as apparel, footwear and specialty chemicals. They also, as a group, were losing money from their operations. And as a whole, they showed a much higher level of insider ownership with an average of 19.1 percent of shares held by insiders. S&P 500 companies, by comparison, have about 3.4 percent of shares held by insiders.

So, what does this all mean?

One critical difference between our study and prior studies is the equity capitalization of the public companies in our sample—our companies were quite small. But our study of smaller firms bears out the conclusions drawn from the previous studies on larger firms: Unprofitable companies—even those that are small—with significant control in the hands of management, tend to have their cash valued at a material discount.

Smaller companies may be unprofitable because of poor investment opportunities, which we know from prior research of larger companies decreases the value of the cash holdings. Smaller companies may have depressed share prices because they don't have good (or any) analyst coverage by Wall Street and potential investors may be unaware of the unique pricing of these smaller companies. Smaller companies also can have limited trading in their shares, which may not have been completely eliminated in our screening, also depressing the share price and further increasing the cash discount.

Surprise Special Dividends

The second part of our analysis studied the payment of special dividends and was intended to be more predictive in determining the size of the cash discount.

We searched for U.S. non-financial, public companies that had paid a special dividend to shareholders in the period from Jan. 1, 2005 to Oct. 7, 2009. This search yielded a total of 408 special dividends. We reduced this sample to capture companies that had made only one special dividend, to eliminate companies that made regular special dividends. We made this elimination because we wanted the special cash dividend to be a surprise to the investors.

> Even if a company is doing well, it may make sense to discount its cash holdings.

We also eliminated companies in which the dividend was less than 5 percent of the share price, because we wanted the dividend to be material (as opposed to small changes in the share price that occur with normal trading.) We included companies that held cash and equivalents greater than 15 percent of total assets to focus on how investors valued excess cash, versus cash simply required for operations. (By comparison, S&P 500 companies held a median cash balance of 7.7 percent of total assets.) We also eliminated companies in which the average daily trading volume for the three months prior to our analysis was less than 1 percent of shares outstanding to eliminate the impact of share liquidity. Finally, we eliminated many companies because of material announcements or events surrounding the special dividend announcement date. For example, if a company announced earnings or a management change on, or within a few days of the special dividend

announcement, we omitted that company. This elimination was to avoid tainting the market reaction to the special dividend announcement with other information that could impact the stock price. After making all these eliminations, we were left with 16 special dividend transactions.

The companies that made up the 16 transactions had an average equity market capitalization of about $1.25 billion and an average pre-tax return on assets of 13.2 percent. In comparison with the companies in Part 1 of our research, these companies tended to be larger and more profitable. These companies also carried an extraordinary amount of excess cash, with cash and equivalents totaling an average of 47.7 percent of total assets. Interestingly, these companies also had a very high degree of insider ownership with an average of 22.2 percent of shares owned by management or directors–consistent with Part 1 of our analysis. The stock prices of these 16 companies increased an average of 72.3 percent (median of 65 percent) of the special dividend amount, when comparing the stock price three days before the announcement with the stock price three days after. This implies that the market had valued each dollar of excess cash at $0.28 to $0.35 previous to the announcement.

Thus, because these companies had entrenched management and large cash balances, their cash was significantly discounted by the market, even though the companies were fairly large and profitable.

Now What?

It's your duty as a wealth advisor to make sure your clients are not exposed to material valuation errors and potential overpayment of estate and gift taxes. If a company has entrenched management and poor investment opportunities, excess cash should be discounted significantly. And in certain instances, even if a company is doing well, it may be appropriate to discount excess cash when valuing minority interests. TE

Endnotes

1. One could argue that if the value of cash is less than face value in calculating enterprise values and multiples for comparable companies, the net effect on the subject company valuation is negligible. Serious valuation errors can still occur though, when either the comparable or transaction companies don't have excess cash, but the subject company does.
2. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Volume II, London: Strahan and Cadell (1776), at p. 229.
3. Amy Dittmar and Jan Mahrt-Smith, "Corporate Governance and the Value of Cash Holdings," *Journal of Financial Economics* (January 2005), at pp. 599-634.
4. *Ibid.*
5. *Ibid.*
6. *Ibid.*
7. Stewart C. Myers, "Determinants of Corporate Borrowing," *Journal of Financial Economics* (November 1977), at pp. 147-176.
8. This is referred to as the "free cash flow theory," first posed by Michael C. Jensen, Emeritus Professor at Harvard University, in the 1980s.
9. Robert Chirinko and Huntley Schaller, "A revealed reference approach to understanding corporate problems: Evidence from Canada," *Journal of Financial Economics* (2004), at pp. 181-206.
10. Lee Foster Pinkowitz and Rohan G. Williamson, "What is a dollar worth? The market value of cash holdings," Working Paper, Georgetown University, Washington (2005).

SPOTLIGHT

Perspective–René Magritte's "*Le baiser* (*the kiss*)," about 10 inches by 13 inches, gouache on paper, sold Feb. 2, 2010, for U.S. $1,946,043 at Christie's "The Art of the Surreal" evening sale in London.