801.10

Verne, B. Michael

From: [redacted]
Sent: Thursday, April 05, 2012 12:13 PM
To: Verne, B. Michael; Walsh, Kathryn
Subject: Question Regarding Valuation

Mike and Kate,

I hope all is well with you both.

I have what I think is a straightforward analysis, but as always, would appreciate your confirmation (or corrections).

For purposes of this hypothetical, let's assume the parties meet the applicable size-of-person thresholds. Buyer plans to acquire voting securities, non-voting securities, and options of Target. Prior to closing, the options will be converted to non-voting securities. The non-voting securities give the shareholders the right to vote on a change of control of the Target, but do not give the shareholders the right to vote for directors of the board. There is a base purchase price for all the securities of $60 million, and shareholders of the voting and non-voting securities will receive the same amount of cash consideration.

The number of shares in each class are as follows:

- Voting = 10 million
- Non-Voting = 2 million
- Options (to be converted to non-voting) = 500,000

Taking the base price of $60 million and dividing it by the total number of shares (i.e., 12,500,000 shares/options) gives us a per share price of $4.80.

For purposes of determining size-of-transaction, we would exclude the non-voting shares and options, which means the base price would be the number of voting shares (10 million) multiplied by the per share consideration of $4.80 for a total of $48 million.

Per the transaction agreement, additional adjustments will be made to the base price including:

- Working capital adjustment (yet to be determined, and may not occur at all if Target hits the pre-determined working capital target);
- A <u>deduction</u> in the consideration for third-party indebtedness (approximately $5 million);
- A <u>deduction</u> in the consideration for stockholder indebtedness (approximately $3 million), with an <u>offsetting addition</u> to the consideration in the same amount (the purpose of this is to ensure the stockholders with the indebtedness effectively pay back their indebtedness, but the stockholders without the indebtedness are not "penalized" by getting reduced consideration); the net effect on the consideration of this deduction/addition is $0;
- A contingent earnout between $5 million and $25 million, but that Buyer reasonably expects will total $15 million.

Applying these adjustments to the base price of the <u>voting</u> securities (with the exception of the yet-to-be-determined working capital adjustment), and assuming the contingent earnout is not so speculative as to warrant a fair market valuation, the size-of-transaction would be approximately $58 million ($48m - $5m +$0m +$15m).

If the working capital adjustment and contingent earnout are in fact too speculative to be reasonably estimated, the acquisition price would be undetermined, and the Buyer would need to do a fair market valuation of the voting shares to be acquired (excluding the non-voting shares).

Please confirm that in determining the size-of-transaction, the non-voting shares and options that do not include a present right to vote for members of Target's board of directors should be excluded. Also, please confirm that it is appropriate for the Buyer to include a reasonable estimate of the working capital adjustment and contingent earnout when determining the size-of-transaction. However, if Buyer cannot reasonably estimate the working capital adjustment and/or the contingent earnout, the acquisition price is not determined, and Buyer needs to do a fair market valuation of the voting shares (excluding the non-voting shares) to be acquired pursuant to Rule 801.10.

Many thanks,

[redacted]

BM
4/5/12