The ESOP Association
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Advanced Valuation Issues

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Goals of the Session

- Identify significant value drivers and/or complex valuation considerations
- Provide context of these items to enable trustees to address them in their valuation review
- Provide our view of how these issues are typically addressed in valuations
- Provide our view of the impact of alternative ways to treat these items
- Facilitate a discussion around the foregoing, and answer relevant questions

Topics

- Normalizing Adjustments to Financial Statements
- Management Budgets/Forecasts/Projections
- Non-Operating Assets/Working Capital
- Repurchase Obligation
- Debt Impact
- Synthetic Equity
- **Questions/Topics from the Audience**

Normalizing Adjustments to Financial Statements

- How are adjustments to the financial statements derived, and how important are they to the valuation opinion?
- The reported financial statements of many closely held companies do not always reflect economic reality
  - Extraordinary / non-recurring items
  - Discretionary items
  - Various management decisions
  - Benefit levels
- See the following slide for an example of normalizing adjustments to financial statements

Normalizing Operating Expenses

	2014	2015	2016
Total Operating Expenses	$6,850	$6,500	$7,350
Less: Non-Recurring Professional Fees	0	-25	-50
Less: Severance Expense	-100	0	0
Less: Discretionary Bonuses	-185	-220	-300
Plus: Bad Debt Recovery	0	500	0
Normalized Operating Expenses	**$6,565**	**$6,755**	**$7,000**
Delta (From Reported Total Op. Expenses)	*($285)*	*$255*	*($350)*
% Change in Operating Expenses	*-4.16%*	*3.92%*	*-4.76%*

Management Budgets/Forecasts/Projections

Issue

- How much reliance should the valuation advisor place on management projections, and how much due diligence on the projections is required in the valuation process?
- What should the valuation advisor do if he/she doesn't believe that a company has a realistic chance of achieving the forecast, either short term or long term?

Management Budgets/Forecasts/Projections Continued

Background

- Valuation is necessarily forward looking, so whatever valuation approach is used, the valuation advisor is assessing the ability of a company to perform in the future.
- Under a traditional discounted cash flow approach, commonly used by most valuation professionals, an explicit forecast provided by management.
- While there are ways of mitigating its impact, it is likely a key component of most valuations.
- See the following slide for an example of a forecast provided by a company.

Management Budgets/Forecasts/Projections Example

	2013A	2014A	2015A	2016A	2017P	2018P	2019P
Total Revenues	$14,850	$15,000	$16,250	$15,750	$18,500	$20,250	22,000
Revenue Growth	*N/A*	*1.0%*	*8.3%*	*(3.1%)*	*17.5%*	*9.5%*	*8.6%*
Cost of Revenues	7,500	7,650	8,500	8,250	9,000	9,750	10,250
As a % of Revenue	*50.5%*	*51.0%*	*52.3%*	*52.4%*	*48.6%*	*48.1%*	*46.6%*
Gross Profit	7,350	7,350	7,750	7,500	9,500	10,500	11,750
Gross Profit Margin	*49.5%*	*49.0%*	*47.7%*	*47.6%*	*51.4%*	*51.9%*	*53.4%*
Operating Expenses	5,500	5,750	5,650	5,950	6,500	6,750	6,900
As a % of Revenue	*37.0%*	*38.3%*	*34.8%*	*37.8%*	*35.1%*	*33.3%*	*31.4%*
EBITDA	1,850	1,600	2,100	1,550	3,000	3,750	4,850
EBITDA Margin	*12.5%*	*10.7%*	*12.9%*	*9.8%*	*16.2%*	*18.5%*	*22.0%*

A: Actual
P: Projected

Non-Operating Assets/Working Capital

Issue

- The value of a company derived through various earnings measures generally assumes a required level of assets that is necessary to generate those earnings (operating assets).
- How is a valuation impacted when a company owns assets that it doesn't need or use to generate future earnings (non-operating assets), or needs assets that it doesn't have?
- Is there any reason to include current debt as part of working capital?
- Should cash be included or excluded in the calculation of working capital?

Non-Operating Assets/Working Capital Continued

Background

- Whether it is excess working capital, appreciated real estate, life insurance, notes receivable, or other non-operating assets, ownership of many of these assets are not required to generate earnings.
- It is appropriate to add non-operating assets to the value of the "operating business," and they may be significant value drivers.
- See the following slide for an example.

Non-Operating Assets/Working Capital Example

Total Invested Capital	**$10,000**
Less: Interest Bearing Debt	(2,500)
Plus: Excess Working Capital	1,000
Plus: Appraised Value of Non-Operating Real Estate	6,500
Plus: ESOP Loan Tax Shield	500
Total Equity Value	**$15,500**

*Note: An imputed rent expense was subtracted from EBIT to derive total invested capital

Repurchase Obligation

Issue

- Should the repurchase obligation ("RO") be taken into consideration in the valuation?
- Should there be a formal analysis of the repurchase obligation?
- If so, who should do the analysis?
- Is it different for newly formed ESOP's?
- Is this a valuation issue at all?

Repurchase Obligation Continued

Background

- The RO should be considered in the valuation (supported by a White Paper from the national ESOP Valuation Advisory Committee).
- Many times, there is no formal RO study, and often no analysis of the RO at all.
- Three common ways this is addressed:

  1. Reflected within the forecast based on actual expected levels. (Economic reality).
  2. Reflected within the forecast based on a normalized benefit level.
  3. As a specific deduction to value.

Debt Impact

Issue

- How should various forms of debt be treated in the valuation of a company?
- Should debt be marked-to-market in certain situations?

Synthetic Equity

Issue

- Does synthetic equity (stock options, phantom stock, SAR's, etc.) impact a company's value today, even though it is currently non-dilutive?
- If so, how should the dilution or impact on value be measured?
- Is it different if the form is options, warrants, SAR's or phantom stock?
- What if it is a management bonus plan?

Synthetic Equity Continued

Background

- Synthetic equity can take various forms, and is a benefit to the holder.
- There are different ways to measure the impact and even separately value forms of synthetic consideration.
- How these are treated in the valuation can often change the answer, and sometimes dramatically.

Topics from the Audience

Thank You!

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