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VALUATION CONSULTANTS

Employee Ownership Strategies: Building High Performance, Inclusive Companies for the 21st Century

Rutgers School of Management and Labor Relations/Santa Clara University NY/NJ Center for Employee Ownership

How is Value Determined: Establishing Value and The Appraisal Process in 2017 Regulatory Environment

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Presentation Overview

- REGULATORY FRAMEWORK
- THE VALUATION PROCESS
- ESTABLISHING VALUE
  - Adequate Consideration – FMV in Good Faith by Trustee
  - Fair Market Value – performed at least annually by "Independent Appraiser" working for Trustee

REGULATORY FRAMEWORK

- An ESOP Appraisal must satisfy two regulatory authorities:

  - **Internal Revenue Service**
    - Tax Benefits are Statutory
    - Historically Little Direct Oversight

  - **Department of Labor**
    - Regulates ERISA
    - Reviews Compliance of Documents
    - Reviews Valuation Report
    - Applies Proposed Regulations & Its Opinions are Subjective and Often Controversial
    - Very Active in Past 10 Years

The Valuation Process

Initial Engagement

- The Process has changed significantly over time:
- Current Process Post DOL / GreatBanc Settlement
  - BV Appraiser should not be engaged by "Committee for the ESOP Formation" and preliminary valuation report should not be shared with Company/seller.
  - Prospective ESOP Trustee should be brought into process up front and directly engage the BV appraiser.
  - Sellers/Company should have own and separate financial advisors or at least should not engage or review ESOP's BV appraiser's work.
  - Consultants/BV appraiser hired by company/seller to conduct an ESOP feasibility study cannot be the Trustee's financial advisor. Prospective Trustee can utilize its BV appraiser/financial advisor to conduct an ESOP feasibility study however report only to go to the Trustee.
  - DOL wants clear evidence of price negotiation between Seller and ESOT.
  - DOL wants Trustee to receive, review and approve valuation report reasonable concurrent with transaction date. Question: what constitutes dated.

The Valuation Process

Initial Engagement - continued

- Initial ESOP Valuation - commonly two STAGES
  - 1st Stage – abbreviated front end narrative
    - Develop range in values
    - Full valuation exhibits for prospective Trustee
    - Trustee / seller to decide to proceed to Stage 2; either can decide to terminate.
    - Before % being sold to ESOP is determined.
    - Before specific terms are established
  - 2nd STAGE – up to closing
    - Seller/Company/Trustee decide to move to Stage 2.
    - Negotiation of price, terms and other transaction related agreements such as compensation, SARS, options, financing terms, CNC, etc.
    - Preliminary Appraisal updated to full detailed report with current market and to reflect actual transaction terms.
    - Closing – no Change letter and Fairness Opinion

- Initial ESOP Valuation – Alternative where seller/company already decided to form ESOP
  - 1st Stage – full detailed report - generally for smaller less complicated ESOPs
  - 2nd Stage – to Closing – No Change letter/ Fairness Opinion.

The Valuation Process

Valuation Report Layout

- Descriptions of the Assignment
- Business Profile
  - History
  - Operations
  - Facilities
  - Customers/Suppliers
  - Employees/Management
  - Outlook
- Industry & Economic Outlook
  - Macro / Regional – focus on pertinent data if available
- Financial Review
  - History & Projections / Adjustments
  - Industry & Guideline Company Comparisons
- Valuation Analysis

DUE DILIGENCE PROCESS IS TO GATHER THE INFORMATION NEED TO FULLY UNDERSTAND TO COMPANY, QUANTIFY ARNINGS EXPECATIONS & ASSESS RISK, FULLY INFORM THE TRUSTEE OF ALL PERTINENT ISSUES AND TO EVENTUALLY WITHSTAND REGULATORY OVERSIGHT

The Valuation Process

Financial Information Requests

–List and sales to top (5-10) customers/clients

- List and purchases from top 3-5 suppliers/sub-contractors
- Owner(s) compensation, including benefits and personal expenses
- Contingent or off-balance sheet assets or liabilities – need to quantify
- Quantification of financial impact of new products, locations, divisions
- Prospective financial information – next year's budget / multi-year projections
- Non-recurring income & Expenses Items
- Segregate income & expenses for non-operating assets or liabilities
- Discretionary expenses
- Depreciation/amortization schedules and identify 179 deductions

The Valuation Process

Non-Financial Information Requests

- Nature, background, and history of the Business
- Facilities of the entity
- Organizational structure
- Management team (officers, directors, and key employees)
- Products and/or services
- Economic environment
- Geographical markets
- Industry / markets served
- Competition (private & publicly traded)
- Business risks
- Business strategy and future plans
- Governmental or regulatory environment

LEVELS OF RELATIVE VALUE

Synergistic (Strategic) Value

Acquisition Premium

Controlling Interest Value

Premium For Control

Minority Interest Discount

Marketable Minority Interest Value
As-IF-Freely-Traded Value

Lack of Marketability Discount

Nonmarketable Minority Interest Value

LEVELS OF RELATIVE VALUE

ESOP buying more than 50%

- **Market Approaches**
  - Guidelines Publicly Traded Company Method
    - **DOL argues Little to no Control Adjustment**
  - Guidelines Merged and Acquired Company Method
    - **DOL Argues a Lack of Control Discount**

- **Income Approach**
    - **DOL argues Little to no Control Adjustment**

- **Asset Approach**
    - **DOL Argues a Lack of Control Discount**

Business Valuation Approaches

- Market Approaches
  - Guidelines Publicly Traded Company Method
  - Guidelines Merged and Acquired Company Method
- Income Approach
  - Discounted Cash Flow Method
  - Capitalization of Historical Income Method
- Asset Approach
  - Adjusted Book Value Method
- Vast Majority of ESOP Appraisals utilize an Income and a Market Method

Market Approach

Guideline Publicly Traded Company Method

- Selection of guideline companies (or transactions);
- Calculation of market multiples (debt free basis) and fundamentals from guideline companies;
- Computation of subject company earnings fundamentals in comparison with subject company;
- Comparative risk analysis of subject company and publicly traded guideline companies;
- Selection of the risk adjusted market multiples to apply to the subject company earnings fundamentals; and
- The determination of value for the subject company's total invested capital or equity.

Example of Market Data Used

	Valuation Date Trading Data				Valuation Multiples		
					MVIC / EBITDA		
Company	**Share Price**	**% 52-week High**	**Market Cap**	**MVIC [1]**	**TTM**	**3-yr AVG**	**5-yr AVG**
Guideline Company A	$7.56	65%	$162	$227	6.0 x	5.4 x	4.9 x
Guideline Company B	$3.22	85%	$51	$95	5.8 x	5.2 x	4.1 x
Guideline Company C	$6.06	95%	$97	$151	10.1 x	10.6 x	10.7 x
Guideline Company D	$11.31	68%	$411	$411	3.7 x	3.8 x	4.0 x
Minimum	$3.22	65%	$51	$95	3.7 x	3.8 x	4.0 x
Maximum	$11.31	95%	$411	$411	10.1 x	10.6 x	10.7 x
Average	$7.04	78%	$180	$221	6.4 x	6.2 x	5.9 x
Median	$6.81	76%	$129	$189	5.9 x	5.3 x	4.5 x
					4.8 x	**4.9 x**	**4.5 x**

	Growth Rates				Debt Ratios		
	Revenue		EBITDA [2]				
Company	**1-Yr**	**5-Yr**	**1-Yr**	**5-Yr**	**Debt / EBITDA**	**Debt / Assets**	**EBITDA/ Interest**
Guideline Company A	0.6%	1.4%	-25.8%	-6.0%	1.7 x	16.4%	7.5 x
Guideline Company B	-3.6%	-3.1%	-52.7%	-26.7%	2.7 x	14.9%	-0.2 x
Guideline Company C	10.1%	0.7%	52.8%	0.7%	3.6 x	22.1%	1.8 x
Guideline Company D	35.4%	18.2%	31.8%	12.5%	0.0 x	0.0%	28.8 x
Minimum	-3.6%	-3.1%	-52.7%	-26.7%	0.0 x	0.0%	-0.2 x
Maximum	35.4%	18.2%	52.8%	12.5%	3.6 x	22.1%	28.8 x
Average	10.6%	4.3%	1.5%	-4.9%	2.0 x	13.4%	9.5 x
Median	5.3%	1.1%	3.0%	-2.7%	2.2 x	15.7%	4.6 x
Subject Company	**7.8%**	**-4.1%**	**101.0%**	**-12.0%**	**1.9 x**	**18.5%**	**11.7 x**

(1) EBITDA = adjusted earnings before net interest, taxes, depreciation and amortization.
(2) MVIC = market value of invested capital (i.e., market value of equity + total debt - cash).

Discounted Cash Flow Method

- The determination of the appropriate future income (free cash flows) to discount, based upon projected income statements, balance sheets, cash flow statements for the subject company.
- The selection of an appropriate discount rate for the subject company projections.
- The determination of a terminal value for the subject company, as of the end of the last period for which projections are available.
- The NPV is the aggregate value for the subject company's total value of invested capital (debt free basis) or equity.
- Most DCF analysis are on a debt-free basis.

Discounted Cash Flow Method

			2012	2013	2014	2015	2016	Terminal
Total Revenues			$ 23,500,000	$ 27,000,000	$ 30,000,000	$ 34,000,000	$ 35,000,000	$ 36,225,000
% Growth				*14.9%*	*11.1%*	*13.3%*	*2.9%*	*3.5%*
COGS (Excluding Depreciation)			$(11,750,000)	$(13,581,000)	$(15,300,000)	$(17,340,000)	$(17,850,000)	$(18,474,750)
% of Revenues			*50.0%*	*50.3%*	*51.0%*	*51.0%*	*51.0%*	*51.0%*
Gross Margin			$ 11,750,000	$ 13,419,000	$ 14,700,000	$ 16,660,000	$ 17,150,000	$ 17,750,250
Gross Margin			*50.0%*	*49.7%*	*49.0%*	*49.0%*	*49.0%*	*49.0%*
Operating Expenses			$ (8,225,000)	$ (9,450,000)	$(10,500,000)	$(11,900,000)	$(12,250,000)	$(12,678,750)
			35.0%	*35.0%*	*35.0%*	*35.0%*	*35.0%*	*35.0%*
EBITDA			$ 3,525,000	$ 3,969,000	$ 4,200,000	$ 4,760,000	$ 4,900,000	$ 5,071,500
EBITDA Margin			*15.0%*	*14.7%*	*14.0%*	*14.0%*	*14.0%*	*14.0%*
Depreciation			$ (609,027)	$ (724,951)	$ (857,017)	$ (968,518)	$ (1,067,346)	$ (1,080,000)
Add back: ESOP Contribution			$ 439,437	$ 483,647	$ 516,398	$ 563,864	$ 613,228	$ 613,228
EBIT			$ 3,355,410	$ 3,727,697	$ 3,859,381	$ 4,355,346	$ 4,445,882	$ 4,604,728
Taxes credit/(taxes)	39.0%		$ (1,308,610)	$ (1,453,802)	$ (1,505,159)	$ (1,698,585)	$ (1,733,894)	$ (1,795,844)
Net Income			$ 2,046,800	$ 2,273,895	$ 2,354,222	$ 2,656,761	$ 2,711,988	$ 2,808,884
Depreciation			$ 609,027	$ 724,951	$ 857,017	$ 968,518	$ 1,067,346	$ 1,080,000
Capital Expenditures			$ (760,009)	$ (1,578,046)	$ (970,921)	$ (1,088,186)	$ (1,186,760)	$ (1,200,000)
Change in Working Capital			280,996	(172,279)	(232,303)	(225,135)	(287,116)	(341,667)
After-tax Cash Flow			$ 2,176,814	$ 1,248,520	$ 2,008,015	$ 2,311,958	$ 2,305,459	$ 2,347,217
Discount Factor	13.15%		0.8838	0.7811	0.6903	0.6101	0.5392	
Discounted Cash Flow			$ 1,923,831	$ 975,184	$ 1,386,128	$ 1,410,463	$ 1,243,038	
Sum of Discrete Cash Flows		$ 6,938,644						
Terminal Value (Gordon Growth Model)		$ 11,883,129						
Value of Invested Capital		$ 18,821,772						
Total Invested Capital		**$ 18,821,772**						

Income Approach – Single Period Capitalization

- Rev Ruling 59-60 stipulates up to consider up to 5-years of Income
- Income can be defined as: NI, OCF, FCF, EBT, DF-NI, DF-OCF, DF-FCF
- Cap rate derivation should be consistent with definition of Income
- Selected normalized income can be compiled in multiple weighting schemes
  - Weighting scheme should reflect company trends & outlook
  - Earning power may reflect average or wtg. avg. from 1-5 years of data
- Weighting scheme to determine earning power can include next year's budgeted/projected income
- Earning Power should be compiled consistent with level of value & purpose of assignment
  - Officers/owners compensation adjustment – subjective and controversial
  - Non-operating & non-recurring items targeted and adjusted
  - Income and expense items for segregated assets/ liabilities must be adjusted

Capitalization of Income Method

		HISTORY 2007	HISTORY 2008	HISTORY 2009	HISTORY 2010	HISTORY 2011	HISTORY 2012
Pre-tax Income		1,000,000	700,000	500,000	600,000	(1,250,000)	100,000
Plus: Interest Expense - Other		84,075	150,944	302,760	277,133	253,242	278,798
Less/Plus: Interest (Income)/Expense		0	0	0	(86,476)	(69,181)	(52,028)
Plus: Non-Recurring Store Opening & R&D Expenses [1]		109,762	4,428	0	0	0	0
Plus: Officer compensation [2]		135,000	135,000	135,000	0	0	0
Minus: Contractual Officer Compensation (3% deflation)		(164,658)	(169,750)	(175,000)	0	0	0
Less: Rental Income [3]		(169,775)	0	0	0	0	0
Less: Income from CSVLI [4]		(2,593)	(2,553)	(2,764)	(2,735)	7,840	0
Plus: Depreciation and Amortization [5]		304,633	90,000	650,000	567,009	2,500,000	253,496
Plus: Non-Recurring Training Expense [6]		0	0	20,000	0	0	0
Plus: Non-Recurring Bonuses [7]		0	0	27,000	0	0	0
Adjusted Debt-Free Pre-tax Income (EBITDA)		1,296,445	908,069	1,456,996	1,354,931	1,441,901	580,266
5-Year Weighting	1,184,251	0	1	2	3	4	3
2-Year Average (2010-2011)	1,398,416	0	0	0	1	1	0
2-Year Weighted Average (2011-2012)	1,154,690	0	0	0	0	2	1
2-Year Average (2011-2012)	1,011,084	0	0	0	0	1	1

Selected EBITDA		$1,200,000
Less Normalized Depreciation & Amortization [5]		($253,500)
Adjusted EBIT (Debt-Free)		$946,500
Less: State & Federal Taxes, Calculated	40.0%	(378,600)
Adjusted Debt-Free Net Income (Cf)		$567,900
Capitalization Rate (r - g)	10.01%	
Aggregate Total Invested Capital (Vo) [11]		$5,857,710
Less: Interest-Bearing Debt on Valuation Date, Rounded		($4,533,000)
Aggregate Fully Marketable Minority Interest Equity Value		$1,324,710

Cost of Equity Build-up	
Normalized 20 Year Treasuries	4.00%
Generic Stock Premium	6.00%
Small Stock Premium	6.50%
Industry/Company Specific Risk	3.00%
Equity Discount Rate	19.50%

Cost of Debt	
Company's Cost of Debt	6.50%
Tax Rate	40.0%
After-Tax Cost of Debt	3.90%

Weighted Average Cost of Capital			
Debt	3.90%	40.0%	1.56%
Equity	19.50%	60.0%	11.70%
WACC			13.26%
Less: Long Term Growth Rate			3.25%
Debt-free Capitalization Rate, Rounded			10.01%

S Corp. Benefit Impacts on Value

Income Methods

- **Standard: After Corporate Taxes for Adjusted Historical and Projected Income**
  - DOL and IRS Disagree on Corporate Taxes for valuation of S-Corp.
  - ESOP Valuation Community **tax affect** earnings
  - Incremental S-Corp Premium not Applied to Aggregate Minority Interest Value
  - Tax Rate is the Marginal Applicable C-Corp Rate

- **S-Corp Status can impact Cost of Capital**
  - Risk of achieving Projected Free Cash Flows Less
  - Ability to service Debt Greater and/ or
  - Ability to invest in Growth Greater

Other ESOP Valuation Considerations

- Non-Operating Assets – ABV Method
  - Excess Working Capital
  - CSVLI & Marketable Securities
  - DOL often has argued Against Segregation on ESOP Buy Side but for on the ESOP sell side.
- ESOP Tax Shield
  - Applies to post transaction Valuation updates
  - Indirect Reduction of Marginal Corporate Tax
- Repurchase Obligation and Discount for Lack of Marketability
  - Normal valuation discount 5% to 10% - vast majority 5%.
  - ESOP has put option and Corporation has redemption obligation
  - Post Transaction in if earning power declines then LOMD can increase.