

Midwest Regional Conference – The ESOP Association  
Omaha, Nebraska – September 7, 2017

# “A Breakdown of the Valuation Report”

---

ERIN D. HOLLIS, ASA, CDBV, DIRECTOR, MARSHALL & STEVENS INC.

HILLARY HUGHES, CFA, DIRECTOR, PRAIRIE CAPITAL ADVISORS, INC.



This presentation examines the valuation report in depth, with focus on approaches, methods, and key points of the valuation analysis; what the trustee (internal or external) should be looking for and what to ask.

There are no “dumb” questions.

As a fiduciary, these are things you need to know about the annual stock valuation.



# KEY COMPONENTS OF THE REPORT

---

1. Entity to be valued (name, type)
2. Valuation date (ex. December 31, 2016)
3. Standard of value (ex. FMV)
4. Ownership interest & value basis (control or minority)
5. Premise of value (going concern)
6. Rights or restrictions (buy-sell agreements)
7. Report date (date final report issued/published)
8. Intended user of the report(ex. ESOP Trustee)
9. Intended use/purpose of the report (ex. ESOP Administration)
10. Examine and notate extraordinary and limiting conditions



# VALUATION REPORT SECTIONS:

---

- Company Overview
- Industry Analysis
- Economic Overview
- Financial Overview
- Other ESOP Considerations
- Valuation Analysis
- Valuation Discounts & Control Premiums
- Conclusion
- Supporting Exhibits

## KEY POINTS

- Are any sections missing?
- Cohesiveness
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_



MIDWEST CONFERENCE

# COMPANY OVERVIEW— NON-FINANCIAL FACTORS:

- History
- Type/date of corporation
- Products or services
- Markets and customers
- Seasonal or cyclical factors
- Competition
- Suppliers
- Key personnel
- Management
- Employees
- SWOT
- Business plan for operation, strategic initiatives, and growth
- Goodwill factors

## KEY POINTS

- Unbiased & factual
- Insightful & timely

○ \_\_\_\_\_

○ \_\_\_\_\_

○ \_\_\_\_\_



MIDWEST CONFERENCE

# INDUSTRY ANALYSIS:

- Industry trends
- Competition
- Industry outlook
- Impact of the industry on the company
- Growth expectations for the company
- Valuation methods commonly utilized in the industry

## KEY POINTS

- Correlation or lack thereof with Company's forecast
- Insightful & timely
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_



MIDWEST CONFERENCE

# ECONOMIC ENVIRONMENT:

- Global, National, Regional and/or Local
- Impact of economy on company
- Company's position in the relevant economy
- How economic indicators affect company (services, market share, growth, etc.)

## KEY POINTS

- Correlation or lack thereof with Company's forecast
- Does this support key underlying value assumptions (long-term growth, risk-free rate, earnings potential?)

- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_



MIDWEST CONFERENCE

# FINANCIAL ANALYSIS:

## Historical:

- Liquidity
- Profitability
- Leverage/capitalization
- Turnover ratio analysis
- Common-sized financial analysis
- Comparative financial analysis

## Measurements of Section D:

- ROA
- ROE
- EBIT margin
- EBITDA
- Ratio of capex to sales
- Revenue growth rates
- Free CF to sales

## KEY POINTS

- What is driving performance?
- What level of capital is required for performance to continue? (Working capital and capital expenditures)
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_





# FINANCIAL ANALYSIS - NORMALIZATIONS:

---

- Level of earnings: Control or minority
- Discretionary expenses
- Non-business related assets
- Real estate (rent)
- Bad debt
- Officers compensation
- Working capital (excess or deficit)
- Inventory (obsolescence)
- Shareholder, related party notes



## KEY POINTS

- Are they needed?
- Are adjustments consistent?
- Is anything double counted?
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_

# OTHER ESOP CONSIDERATIONS:

---

- ESOP Internal Loan Amortization
- Repurchase obligation
  - Planning and funding
- Synthetic equity, SARs, warrants, options
- Treatment of contingent purchase consideration
  - Earnout or clawback

## KEY POINTS

- Appraisers treatment of ESOP and any adjustments should be clearly stated and explained
- If you do not understand, ask!
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_



# VALUATION ANALYSIS - VALUATION APPROACHES:

---

## Income Approach

- Discounted Cash Flow Method
- Capitalization of Earnings Method

## Asset (Cost) Approach

- Adjusted Book Value Method
- Dual Capitalization of Earnings Method (hybrid)

## Market Approach

- Guideline Public Company Method
- Guideline Transaction Method

### KEY POINTS

- Enterprise vs Equity
- Control vs Minority
- What is missing and why?
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_



MIDWEST CONFERENCE

# INCOME APPROACH

## Key Assumptions:

- Cash flow forecast
- Depreciation/amortization, capital expenditures
- Working capital
- ESOP benefit levels
- Discount Rate
- Long-term growth

## KEY POINTS

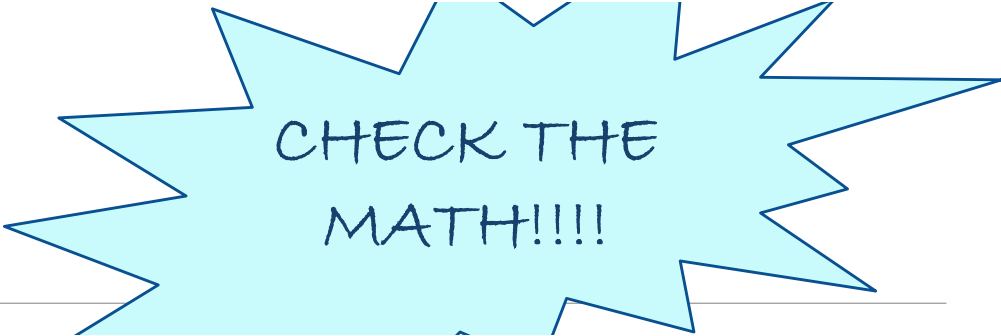
- Does the forecast make sense?
- Are the inputs consistent?
- Implied valuation multiples
- Where is the value coming from?

- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_



MIDWEST CONFERENCE

# DCF METHOD



Free Cash Flow Calculation \$ thousands	Forecast										Terminal
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	Year
EBITDA	\$ 15,602	\$ 17,666	\$ 19,802	\$ 22,338	\$ 24,329	\$ 25,546	\$ 26,823	\$ 28,164	\$ 29,572	\$ 31,051	\$ 32,603
Depreciation and Amortization	(3,551)	(3,586)	(3,235)	(3,509)	(3,039)	(3,243)	(2,577)	(2,761)	(2,948)	(3,143)	(3,300)
Income Taxes [a]	(4,820)	(5,632)	(6,627)	(7,532)	(8,516)	(8,921)	(9,698)	(10,161)	(10,650)	(11,163)	(11,721)
Debt-Free Net Income	7,231	8,448	9,940	11,297	12,774	13,381	14,547	15,242	15,974	16,745	17,582
Depreciation and Amortization	3,551	3,586	3,235	3,509	3,039	3,243	2,577	2,761	2,948	3,143	3,300
Capital Expenditures	(1,861)	(2,457)	(2,629)	(2,813)	(3,010)	(3,160)	(3,318)	(3,484)	(3,659)	(3,841)	(3,300)
Working Capital Requirements	(3,305)	(4,521)	(4,837)	(5,176)	(5,538)	(4,233)	(4,444)	(4,666)	(4,900)	(5,145)	(5,402)
Free Cash Flow, Debt-Free	5,816	5,057	5,710	6,818	7,265	9,232	9,362	9,852	10,364	10,902	12,180
Discount Factor @13.50%	93.8%	82.7%	72.8%	64.2%	56.5%	49.8%	43.9%	38.7%	34.1%	30.0%	
NPV of Free Cash Flows	\$ 5,457	\$ 4,180	\$ 4,159	\$ 4,375	\$ 4,108	\$ 4,599	\$ 4,109	\$ 3,810	\$ 3,531	\$ 3,272	

Terminal Value Calculation		Enterprise Value Calculation		Enterprise Value Range			
				Low	Mid	High	
Terminal Growth Rate	5.0%	PV of FCFs (Years 1-10)	\$ 41,601	WACC	13.75%	13.50%	13.25%
Free Cash Flow (t+1)	\$ 12,180	PV of Terminal Value	43,015	EV (rounded)	\$ 82,000	\$ 85,000	\$ 87,000
Capitalization Rate (k-g)	8.50%	Terminal Value (% of EV)	50.8%	EV / 2017 EBITDA	5.3x	5.4x	5.6x
Terminal Value	143,296			EV / 2016 EBITDA	6.2x	6.4x	6.5x
PV Factor	0.3002						
Implied Terminal EBITDA Multiple	4.6x	EV, Mkt. Min.	\$ 84,616				

[a] Assumes a 40.0% tax rate.



# MARKET APPROACH

A method of determining a value indication of a business asset by using one or more methods that compare the subject to similar businesses that have been sold.

## Guideline Public Company Method

- Public company data

## Guideline Transaction Method

- Private company transactions

### KEY POINTS

- Selection process
- Comparability
- Margin & performance analysis
- Adjustment to Multiples
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_



# ASSET APPROACH

## Adjusted Net Asset Value Method

- Based on an accrual basis balance sheet
- Assess the fair market value of each asset account and liability
- Identify any off-balance sheet assets or liabilities (intangibles, shareholder loans, covenants, etc.)
- Net the fair market value of the assets against the liabilities

### KEY POINTS

- Rationale & consistent
- Is marketability double counted?
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_



MIDWEST CONFERENCE

# DISCOUNTS AND PREMIUMS:

---

- Control premium/Lack of control (minority discount)
  - Should be reflective of value basis employed
- Lack of marketability (marketability discount)
  - Should not be solution for purchase obligation

## KEY POINTS

- Not additive, cumulative
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_



MIDWEST CONFERENCE



# VALUATION REPORT RECAP

---

- Company Overview
- Industry Analysis
- Economic Overview
- Financial Overview
- Other ESOP Considerations
- Valuation Analysis
- Valuation Discounts & Control Premiums
- Conclusion



## KEY POINTS

- Is it written in plain English?
- Does the conclusion make sense?
- Consistency throughout report
- Exhibits match the text of the report
- CHECK THE MATH!
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_

# COMMON VALUATION ERRORS

---

- Incorrect standard of value applied
- Inappropriate normalizations – double counting discounts or premia (control v minority)
- Inappropriate application of methodology
- Forecasts are not reasonable, defensible, or unaffected by conflicts
- Economic and industry overviews do not tie with financial analysis of subject entity
- Ignores synthetic equity or deferred compensation liability or dilution
- ESOP Adjustments



MIDWEST CONFERENCE

marshall

stevens



# ERIN D. HOLLIS, ASA, CDBV

**Erin D. Hollis, ASA, CDBV**, is a Director at Marshall & Stevens Incorporated. She works within the Chicago financial practice group conducting opinions and analyses for closely-held and publicly-traded entities for litigation, taxation and transactional purposes, and with ESOP clients on financial analysis and consulting services needs.

**Experience** – Since 2000, Ms. Hollis has worked with advisors and closely-held business owners for valuation needs, and has experience providing valuation advisory and economic analysis services in the areas of litigation, taxation, transactional, and planning purposes. Erin has provided professional services in industries, such as manufacturing, construction, transportation, agricultural, distribution, retail, wholesale, and a wide range of service industries.

She is a qualified expert witness, and has testified for various marital and corporate litigation matters. She is a prolific author on the subject of business valuation, and has written for several industry trade publications and as a contributing author for professional organizations. Erin sits on the Business Valuation Committee of the American Society of Appraisers (ASA) and the Valuation Advisory Committee of the ESOP Association .

**Education** – Erin received a B.A. and B.S. from Michigan State University. She is an Accredited Senior Appraiser (ASA) with the American Society of Appraisers, and Certified in Distressed Business Valuation (CDBV) with the Association of Insolvency & Restructuring Advisors (AIRA).



# HILLARY HUGHES, CFA



Hillary Hughes is a trusted advisor on ownership transition. She provides strategic insights to assist business owners and board of directors to address long term ownership transaction goals. Ms. Hughes has been highly involved in the structuring and valuation related to Employee Stock Ownership Plans (ESOPs) on behalf of ESOP Trustees as well as business owners. Based out of Prairie Capital Advisors' Cedar Rapids office, Ms. Hughes has provided financial advisory services to clients ranging from small family owned businesses to large multi-national conglomerates. She specializes in the valuation of businesses and business interests for purposes of mergers and acquisitions (M&A), ESOPs, gift and estate planning, and strategic planning.

In addition, Ms. Hughes is a frequent speaker in forums around the country on topics including valuation, ESOPs and ownership transition planning. She is a member of The ESOP Association Valuation Advisory Committee and the Iowa/Nebraska Chapter President. Ms. Hughes is also active in her community and is a member of the Linn County Conservation Board. She is also a Board member for two private companies.

## Education

Ms. Hughes holds two Bachelor of Science degrees in Finance and Agriculture, Business and Economics from Iowa State University. Ms. Hughes currently holds FINRA Series 79 and 63 securities licenses.

## Professional Affiliations

- Accredited Senior Appraiser of the American Society of Appraisers (ASA)
- Chartered Financial Analyst (CFA) Chartholder
- National Center for Employee Ownership (NCEO)
- The ESOP Association

