The ESOP Association
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The Basics of Valuation

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Introduction

Arlene Ashcraft, CFA, ASA

- Arlene is an Accredited Senior Appraiser (ASA) with the American Society of Appraisers designated in business valuation, and holds a chartered financial analyst designation. She is a member of the ESOP Association, and the CFA Institute. Arlene routinely speaks on ESOP valuation issues at conferences and Webinars sponsored by the NCEO and the ESOP Association.

Erin D. Hollis, ASA, CDBV

- Erin is an Accredited Senior Appraiser (ASA) with the American Society of Appraisers, and is a Director in the Financial & Valuation Opinions Group of Marshall & Stevens in Chicago. She has more than 10 years of business valuation related experience for various purposes in a multitude of industries. She is an established author on the subject and serves as an expert witness.

OVERVIEW

- Introduction
- Example company—*FoodCo*
- Definition of Fair Market Value
- Valuation theory & example
- Advanced valuation topics

SUBJECT COMPANY-*FoodCo*

- *FoodCo* operates in the frozen food industry, developing and manufacturing frozen entrée and snacks. All operations are domestic (R&D, food processing, administration). The company had approximately $500 million in annual sales.

SUBJECT COMPANY-*FoodCo*

- *FoodCo* facts:
  - Mature Company
  - Client mix:
    - Grocery Stores 30%
    - Walmart 25%
    - C Stores 25%
    - Warehouse Club Stores 10%
    - Foodservice 5%

  - Agricultural products key input
  - Capital intensive
  - Does not have a strong brand name with consumers
  - Operates in ethnic food niche
  - Value product, not high-end offering

STANDARD OF VALUE:

- "Fair market value" as defined by Revenue Ruling 59-60, ERISA § 3(18)(B) and Proposed U.S. Department of Labor Regulation Section 2510.3-18 (b)(2), as:
  - "The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. The hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well-informed about the asset and the market for that asset."

VALUATION PROCESS:

- Economic environment
- Industry analysis
- Company analysis
- Market analysis

ECONOMIC ENVIRONMENT:

- Global
- National
- Regional
- Local

INDUSTRY ANALYSIS:

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

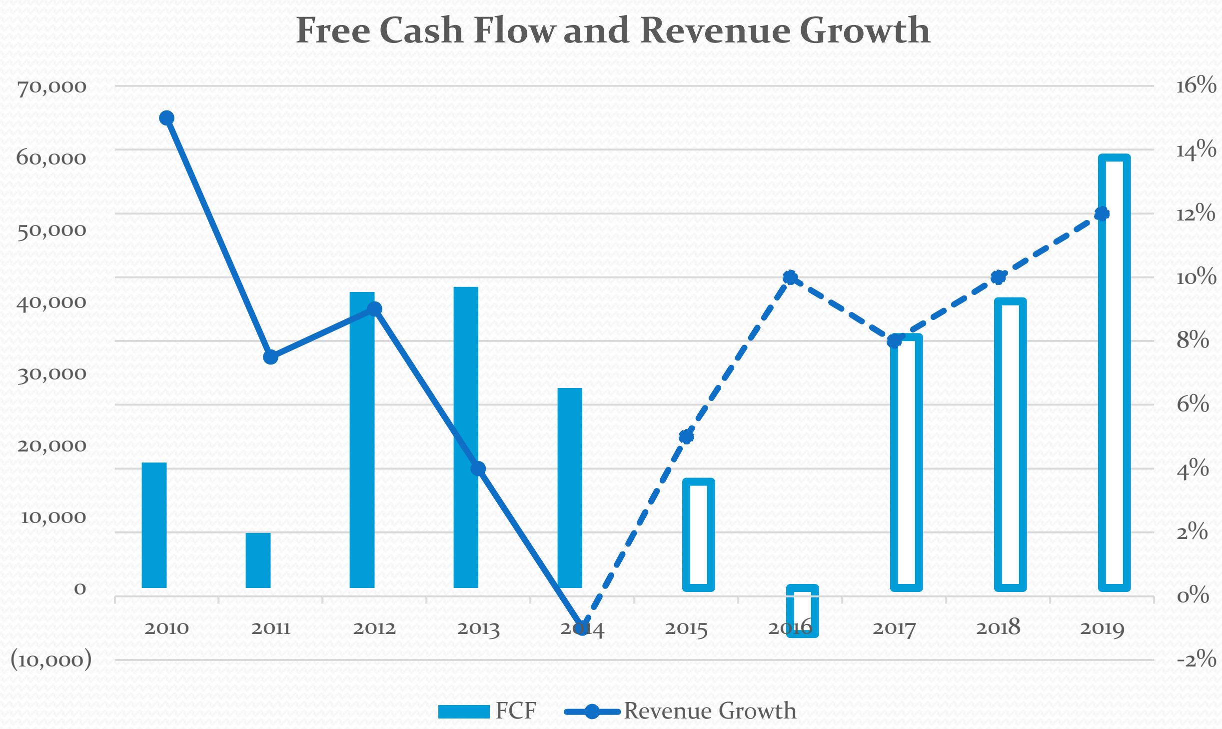
COMPANY ANALYSIS – NON-FINANCIAL FACTORS:

- History
- Products or services
- Markets and customers
- Seasonal or cyclical factors
- Competition
- Suppliers
- Management
- Employees

COMPANY ANALYSIS – FINANCIAL FACTORS:

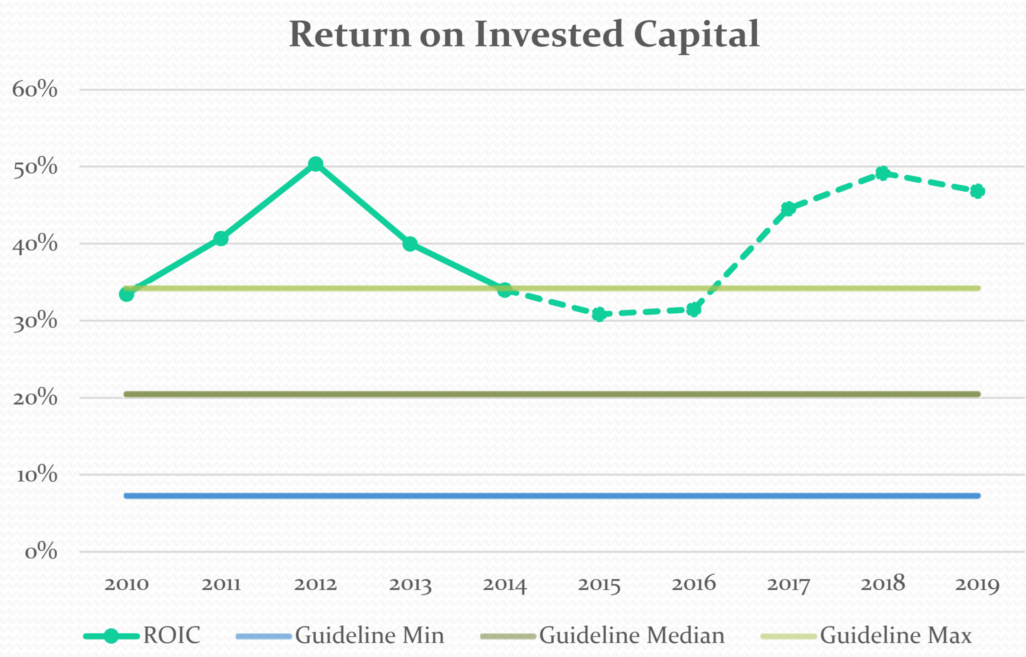
- Historical and Forecasted:
  - Growth
  - Profitability
  - Returns
- Liquidity
- Leverage/Capitalization

COMPANY ANALYSIS: Growth & Cash Flow



COMPANY ANALYSIS: Returns

- Earnings Return on Capital Invested



INCOME APPROACH:

- Discounted Cash Flow (DCF) Method
- Capitalization of Earnings Method

MARKET APPROACH:

- Guideline public company method
- Merger and acquisition method
- Prior (or pending) transaction analysis

ASSET-BASED APPROACH:

- Assets and liabilities restated from historical cost to fair market value

INCOME APPROACH:

- Estimated future returns are discounted to present value at an appropriate rate of return for the investment
  - Free Cash Flow
    - Often 5 years
  - Weighted Average Cost of Capital (WACC)
    - Cost of Debt & Equity

Discounted Cash Flow (DCF) Method

- A multi-period income method
- Free cash flow is projected over a finite period
- Terminal value
  - Cash flow is capitalized to calculate the future value of cash flows into perpetuity beyond the projected period.

DCF Multi-Period Analysis

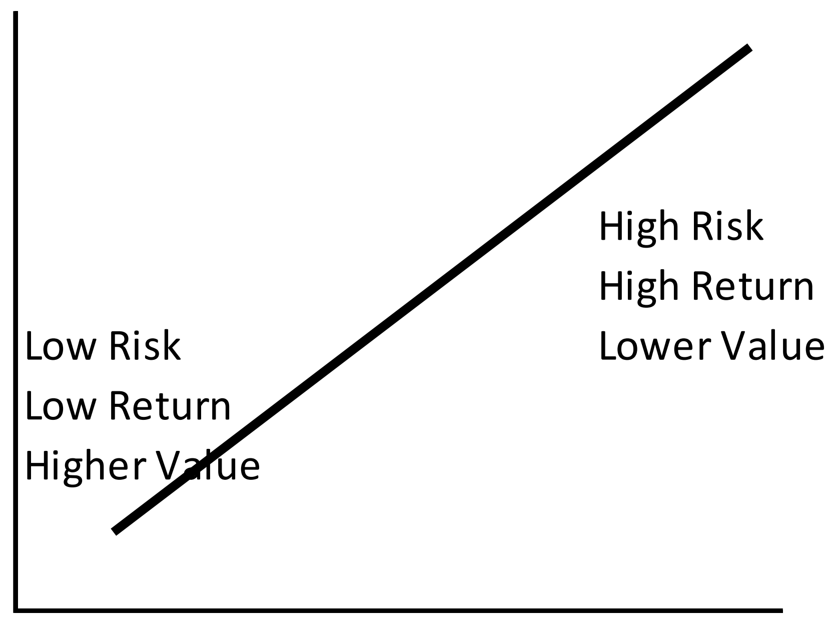
- Future cash flows are projected for a finite period (five years), and the terminal year represents cash flows into perpetuity.

Year One	Year Two	Year Three	Year Four	Year Five	Terminal Year
$1,000	**$1,000**	**$1,000**	**$1,000**	**$1,000**	**$10,000**

Discount Rate

- The expected rate of return (or yield) that an investor would have to give up by investing in the subject investment.
- Includes both Systematic and Unsystematic risk factors.

Required Rate of Return



Capitalization of Earnings Method

- Single period capitalization of earnings analysis.
- Earnings represent expected average cash flows for the foreseeable future.

MARKET APPROACH

- Due to data availability, both a merged and acquired and public company method could be utilized for this subject company.
- Based on the theory of substitution
  - In real estate, appraisers look at data on sales of comparable properties. In business valuation, the theory is the same.

Market Approach:

- Issues with the market approach
  - Comparability
    - Each subject company is different and unique, but companies that have similar growth and risk drivers can still be appropriate to use as comparables
  - Volatility-Particularly Pricing for Public Companies
  - Timely Data & Completeness of Data-Merged and Acquired Companies

- Positive features of the market approach
  - Timely data
    - Incorporates up-to-date perceptions of risks/benefits of investment
  - “Real world” transactions

Market Approach-Example:

1. Select Guideline Companies

Company	Ticker Symbol	Latest Quarter: Interest Bearing Debt	Latest Quarter: Total Assets	Latest Quarter: Total Revenues	Bid/Close Price Per Share	Common Shares Outstanding(a)	Market Value of Common Equity
		$000	$000	$000	$	000	$000
B&G Foods Inc.	BGS	477,988	882,922	535,734	22.05	47,700	1,051,788
Bridgford Foods Corp.	BRID	0	58,131	115,241	8.65	9,207	79,641
Golden Enterprises Inc.	GLDC	7,811	49,255	132,337	3.58	11,735	42,011
High Liner Foods Inc.	TSX:HLF	97,466	362,941	632,885	14.28	15,092	215,576
Inventure Foods, Inc.	SNAK	31,957	102,712	151,374	4.00	18,168	72,672
J&J Snack Foods Corp.	JJSF	801	550,816	744,071	51.23	18,727	959,384
Overhill Farms Inc.	OFI	7,673	65,894	169,397	3.83	15,823	60,602
Seneca Foods Corp.	SENE.A	333,551	1,053,075	1,241,921	21.71	11,736	254,743
Snyder's-Lance, Inc.	LNCE	284,485	1,500,124	1,630,593	20.84	67,788	1,412,702
		Mean	513,986	594,839			461,013
		Median	362,941	535,734			215,576

Market Approach-Example:

2. Adjust financials of Guideline Companies and *FoodCo* to increase comparability

3. Compare Performance (historical and forecasted) of *FoodCo* to guideline group

3. Select fundamentals to use (i.e. most recent earnings, average earnings, forecasted earnings)

4. Select appropriate multiples

Market Approach-Example:

Select appropriate multiples

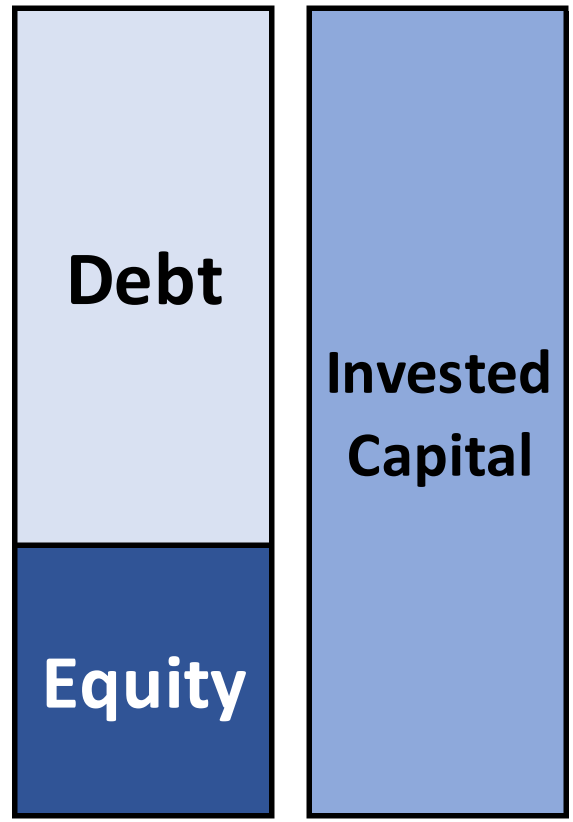
Company	5 - Yr Compound Growth	Earnings Multiple Forecast	Earnings Multiple LTM	Earnings Multiple 5 - Yr Avg.
	%			
B&G Foods Inc.	13.0	10.0	11.8	14.3
Bridgford Foods Corp.	(11.1)	NA	26.6	19.3
Golden Enterprises Inc.	20.5	NA	6.2	8.1
High Liner Foods Inc.	32.4	4.0	6.1	7.9
Inventure Foods, Inc.	26.0	6.6	10.5	11.8
J&J Snack Foods Corp.	7.7	7.9	9.4	10.5
Overhill Farms Inc.	(7.2)	NA	6.1	4.0
Seneca Foods Corp.	(21.6)	8.2	21.2	7.3
Snyder's-Lance, Inc.	NA	9.0	NA	NA
Average	7.5	7.6	12.2	10.4
Median	10.4	8.0	9.9	9.3
FoodCo	5.8	NA	NA	NA

Market Approach-Example:

	FoodCo Fundamental	Guideline Median	Discount	Multiple Selected	Indicated Value
EBITDA					
Latest Year	$40,000	10.0	20%	8.0	$320,000
5 Yr. Average	$48,500	9.0	20%	7.2	$349,200
Forecast	$38,500	8.0	20%	6.4	$246,400
Revenues					
Latest Year	$500,000	0.70	20%	0.56	$280,000

Invested Capital v. Equity Value

- Invested Capital
  - Equity Shareholders
  - Debt Shareholders
    - More debt equates to less equity value.
    - Important component in newly formed ESOPs in a leveraged transaction.



DISCOUNTS AND PREMIUMS:

- Control premium/Lack of control (minority discount)
- Lack of marketability (marketability discount)

Control Premium

- A controlling interest has more rights than a minority
  - Capital structure
  - Board of directors
  - Strategic plan
  - Compensation

Discounts

- Lack of marketability
  - Company is not publicly traded
  - Equity shareholders do not have the same ready, liquid market
  - IRC §409(h)(1)(B)
    - Participants are granted a put right exercisable against the employer upon leaving the company.
    - Upon exercise, they receive FMV for their vested shares per the terms of the employer's plan document.
      - Put rights create a market for the shares

Other Valuation Issues:

- Repurchase obligations
- Synthetic equity, SARs, warrants, options
- ESOP debt
- Claw backs

Questions

Thank You!

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