Troubled ESOPs:

Communicating The Valuation Effects

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This presentation includes two parts — assessing the financial damages and how those damages are likely to affect the value of the Company’s stock.

I. How to communicate that the Company is doing poorly. In a situation where the Company is “doing poorly”, two basic scenarios are possible:

A. In the first scenario, the Company is in a permanent state of decline. In such a case, the employees must be prepared for the liquidation of the Company.

B. In the second scenario, there is at least some hope that the Company will recover from its current situation.

C. I will concentrate on the second scenario. Management should have a plan to allow the Company to recover from its difficulties and should be prepared to communicate that plan to the Company employee/shareholders.

II. How do you measure “doing poorly?”

A. **Balance Sheet**. The balance sheet is an assessment of a company’s *financial position*. An example of a balance sheet is:



The financial position of this company began to decline in 2001. Most economists now agree that our current recession began in the Spring of 2001.

As orders began to decline, the accounts receivable and cash began to decline.

Inventory remained high as the inventory items were not being purchased by customers.

The *working capital*, which is the current assets less current liabilities, began to decline until it was negative in 2003.

\*\*\*\* Without working capital, a company cannot survive. It cannot pay vendors and will ultimately be forced by its creditors into bankruptcy.

B. **Income Statement**. The income statement measures a company’s *financial results*. An example of an income statement is:



As can be seen, revenue and net income are declining here. The income statement begins with revenue (or sales). Then expenses are subtracted and the difference is income (or profits). A graph of the net sales and EBITDA is shown as follows:

(***EBITDA*** is the earnings before interest, taxes, depreciation and amortization. EBITDA is often used by financial analysts as a proxy for operating cash flow.)



Cash flow is a different concept. Because of the complexity, we will not get into the cash flow statements which are shown just below the income statements above.

In general, the remedy for a company like this is to increase revenue and/or reduce expenses. This is where Cindy’s suggestions come into play.

III. Clearly, when the fortunes of a company declines, even temporarily, the value of such a company’s stock is likely to be negatively affected. The appraiser should, however, consider whether the current decline in fortunes is just temporary.

The appraiser must assess whether management and/or the economy can change a poorly performing company’s fortunes.

For a company in a cyclical industry, occasional business declines are to be expected. Before the current recession, many in the economic and general business community believed that, because of fundamental changes in the economy such as just-in-time inventory, there would be no more recessions. That claim was a bit premature.

A. What should the ESOP trustee(s) and the participants expect to see in the Company’s valuation report?

1. A discussion of the economy and its prognosis.

2. An analysis of the industry’s condition and some discussion of how the industry is likely to cope with the current poor economic conditions.

This industry discussion should include a synopsis of the Company’s position in the industry that addresses size and other factors of industry participants, as those factors would affect survival.

Consolidation within the industry is another topic that needs to be addressed. Although consolidation can mean competing with increasingly better-capitalized competitors, it can also mean that there is a strong acquisition market for enterprises such as the Company.

3. A discussion of the Company’s business and financial situation in light of its distressed condition. This should include management’s plan for recovery and a presentation of the financial statements with a projection of expected future results.

The valuation analysis should include some discussion of how the Company’s distressed situation is affecting the estimation of value.

This exhibit (below and on the screen) shows differences between last year’s valuation and this year’s.



In this exhibit, we can see that the value is down by over 15%. Likewise, the cash flow capacity and the EBITDA capacity are also down by about 15%. Prices of guideline companies are down by 17.2%.

If the appraiser feels that management’s recovery plans have little chance of success, of course, the decline in value will be even greater than the profits’ declines might otherwise call for. An assessment of management and its plans for recovery are even more important than the raw numbers.

IV. Discussion Topics.

A. How many here are employees of operating companies as opposed to consultants and other ESOP service providers?

B. How many are employed by companies that are having a tough time in this economy?

C. Of those whose employers are having financial difficulties, how many are aware of a plan of management to extract the company from its difficulties?

D. How many are aware that management has no specific plan?

E. Has management shared its plans with the ESOP participants?

F. If so, what was the reaction of the participants to the plan?

G. Continued discussion.

Beginning Business Valuation

I. There are three valuation approaches:

A. **Asset Based Approach**: A general way of determining a value indication of a business’s assets and/or equity interest using one or more methods based directly upon the value of the assets of the business less liabilities.

Several situations that would call for the asset approach would be as follows:

1. The company being valued is an investment company of some type. For example, it invests primarily in real estate and/or stocks and bonds. A real estate investment trust would be an example of a company where an asset approach might be appropriate.

2. The block of shares being valued is large enough to force a liquidation of the company.

3. The company whose stock is being valued may be liquidated in the near future.

4. The block of shares being valued is a controlling block and the market and asset values are much smaller than the net asset value.

5. We may, in part, use an asset approach if the company whose stock is being valued has non-operating assets. For example, if the company owns real estate that is not being used in the operations of the business, such an asset would be a non-operating asset. The book value of this asset would be subtracted from the total value of the assets of the balance sheet, and the fair market value of this real estate would be added to the operating value of the company. All income generated by this real estate would be eliminated from the income statement.

B. **Income Approach**: A general way of determining a value indication of a business, business ownership interest or security using one or more methods wherein a value is determined by converting anticipated benefits.

The income approach and the market approach are not as distinct from each other as one might suppose.

For example, in the application of the income approach, if we are applying the capitalization of cash flow valuation method, we might use some type of market data upon which to base a capitalization rate or a discount rate. So? Are we using the income approach or the market approach?

For our purposes in this discussion, we will assume that the capitalization of cash flow method and the discounted future cash flow method are both income approaches.

1. **Capitalization of cash flow method**.

a. Estimate the capitalization rate.

There are many ways to do this, but generally the formula is as follows:

Risk-free rate of return (usually 20-year treasury bonds)

Plus Equity risk premium

Plus Small stock premium

Plus Company-specific risk premium

This yields the *discount rate* or *expected rate of return* as it is sometimes referred to.

We then subtract the long-term growth rate to yield the *capitalization rate*.

As complicated and controversial as the estimation of a capitalization rate can be, the estimation of the *cash flow capacity* figure is typically even more difficult.

b. Estimate the *cash flow capacity*. The cash flow capacity (or earning capacity) is the level of sustainable cash flow that a company can maintain excluding extraordinary and non-recurring items.

It can involve using the most recent cash flow figure, some type of averaging or some other estimate.

When the cash flow has a very steady increase, both historically and prospectively, as shown below [on the screen], estimating the cash flow capacity is relatively simple.

The historic cash flows are shown in blue and the prospective cash flows are shown in red. If the projections provided by management are realistic, we would probably lean toward the 2002 cash flow figure as being the cash flow capacity of this company.

When the cash flow is erratic, as shown below [on the screen], deciding on a cash flow capacity is made much more difficult for the appraiser.

Here the company has no discernable pattern of generating cash flow. Also, management’s forecasts appear to bear little resemblance to the company’s historic performance. This makes it difficult for the appraiser.

A simple average or a weighted average may have no relevance depending upon the facts and circumstances.

The mean average of the last four year’s cash flows is $1,131,250. The weighted average for the last four years with increasing weights from one to four is $1,302,500. Yet management predicts that the cash flow for 2003 will be $2,400,000.

So? What is the cash flow capacity that we divide the capitalization rate into?

Let us assume a capitalization rate of 14%.

If we use the mean average of the historic cash flows to estimate the cash flow capacity, the value would be $8,080,357.

If we use the weighted average, the value would be $9,303,571.

If we use the cash flow projected for 2003, the value would be $17,142,857.

You can see the difficult task that is set before the appraiser.

2. **Discounted future cash flow method**.

This method bases the value on the projections of cash flow provided by the management of the company to be valued. We use the discount rate that we covered in the discussion of the capitalization of cash flow method to discount the expected cash flows to the valuation date.

As in the case of the capitalization of cash flow method, we depend upon investment data, in the form of a discount rate and capitalization rate, and cash flows. In this case, the future cash flows were projected by management.

One difficulty of using the discounted future cash flow method is that management can effectively control the ultimate value of the company through its cash flow projections. If management inflates the projections, the value would, of course, be inflated. In the chart that we just discussed, we see that management forecasted much higher cash flows into the future than there were in the past. In the next chart, below [on the screen], we see the classic *hockey stick*.



In the last two charts, we can see that some exploration of the validity of the projections is necessary in order for this valuation method to be used to produce near realistic results.

We keep close track of how reliable the Company is at achieving its projections when we do the valuation annually. When we apply the discounted future cash flow valuation method, the historic reliability of the Company’s projections will be considered in our choice of a discount rate or a probability adjustment.

Another distorting factor in the application of the discounted future cash flow method is the *terminal value*. In the last year of the valuation, we anticipate what the Company will be worth in that year. This figure is usually based upon the cash flow that is expected to be generated by the company in that year. If, therefore, that last year’s cash flow figure is particularly high, the whole valuation may be distorted.

C. **Market Approach**: A general way of determining a value indication of a business, business ownership interest or security using one or more methods that compare the subject to similar businesses, business ownership interests or securities that have been sold.

In a sense, the market approach is very similar to the capitalization of income method. We begin with some measurement of a company’s results and then we apply some type of multiple that is based upon trades of similar businesses.

1. **Market data**. There are several sources of market data, including the following:

a. Publicly-traded stocks of companies in a similar line of business. The comparable company does not have to be a direct competitor of the company being valued, although that would certainly be preferable.

b. IBA (Institute of Business Appraisers) data base.

c. Pratt’s Stats

d. Done Deals

e. Specialized sources such as Zweig’s Valuation Survey, which is for engineering, architectural and environmental consulting companies.

The multiple selected should consider the differences between the company being valued and the comparables used in terms of relative profitability, financial position, competitive strength, management and other factors.

2. **Company results**. This can be net income, cash flow, *owner’s discretionary cash flow*, revenue or some figure from the income or cash flow statement.

Whatever type of company result is chosen must represent the capacity of the company to produce the result chosen. If, for example, we select cash flow, then we must estimate the cash flow capacity in the same way that we selected the cash flow capacity for the application of the capitalization of cash flow valuation method. We thereby face the same difficulties.

III. **Adjustments to value**.

A very simplified illustration of control and marketability adjustments is shown below [on the screen].



A. Non-controlling versus controlling interests.

This is a very complicated issue. There is some question as to whether ESOP stock can be valued on a controlling-interest basis (*Eckelcamp* etc.), whether that valuation is for the initial ESOP purchase or it is for an annual update. For purposes of this discussion, we will assume that it is possible to value ESOP stock on a controlling-interest basis.

1. What is control?

It should be up to the ESOP’s counsel to decide whether the ESOP owns a controlling interest in the company.

“Control” can mean owning over 50% of the common stock and may have something to do with the actual control that the ESOP trustees have over the policies of the company.

2. Minority discount versus control premium.

Different valuation methods applied in different ways may yield either a controlling value or a non-controlling value.

So, if the desired result is a non-controlling interest value, we would not necessarily apply a minority discount since the method being applied may yield a non-controlling (or minority) interest value.

Likewise, if the desired result is a controlling interest value, we would not necessarily apply a control premium since the method being applied may yield a controlling interest value.

Many appraisers believe that the application of the capitalization of cash flow method or the market method using publicly-traded guideline companies yields a non-controlling value. There is some controversy on this subject.

Typically, values yielded by non-publicly-traded companies will be controlling values because the transactions upon which the values are based are sales of whole companies. Then there may be adjustments necessary when the transaction is an asset sale as opposed to a stock sale.

Some appraisers contend that there should be no such thing as a control premium. Their argument is that, if there is a difference between a non-controlling interest and a controlling interest value, that difference would be represented by additional cash flows that would be available to co-owners because of the control. I believe that even if there are no additional cash flows evident from the acquisition of a controlling interest in a company, there is still additional value that accompanies control.

B. Discount for lack of marketability.

If the ESOP stock is not publicly-traded, the stock should be valued on a *non-marketable interest basis*.

Many appraisers believe that the application of the capitalization of cash flow method or the market method, using publicly-traded guideline companies, yields a marketable interest value. In order to translate this marketable interest value into a non-marketable interest value, we typically apply a discount for lack of marketability.

These discounts are often based upon studies of either initial public offering (“IPO”) discounts and/or discounts realized in restricted stock studies. There are a number of IPO and restricted stock studies that appraiser use to help them estimate a discount for lack of marketability.

There are several factors that are typically considered in estimating a discount. They include:

1. The size of the block being valued.

2. The profitability of the company.

3. The financial condition of the company.

4. Any agreement, such as an ESOP trust agreement, that may create a market for the stock of the company.

The final factor is the justification for estimating relatively low levels of discounts for lack of marketability for ESOP stock.

IV. Discussion