Business Value During & After the Recession

Let’s begin with the facts. The economy is in recession, already the longest such contraction since the great depression. The stock market is down, way down. We are approaching double digit unemployment not seen since the early 1980s. Investor expectations and risk perceptions have dashed the valuations of the publicly traded companies which serve as primary benchmarks in the valuation of closely held companies. Your 401-k is likely now a 201-k. Sales, as well as earnings, at your company are likely down, and, yes, the value of your company is likely down.

We have had the unenviable task of delivering the news of down valuations to many clients in this harsh business cycle. In some cases, value was down even when our clients had actually increased sales and earnings. The worlds of business and value have been less than optimal since the onset of the current recession. For our many financial institution clients, the current downturn is more of the same trend that started with the sub-prime mortgage crisis more than two years ago.

Some clients and many appraisers are experiencing their first recession. Those of us more seasoned, if you will, have experienced other recessions and we remember the pain. Living through a recession is a trying thing, and often takes the fun out of business. We have all witnessed examples of business owners, managers, and employees becoming demoralized or even paralyzed by the fear of an unknown future. This tendency to focus inward out of fear and to adopt a pack mentality (everyone else is doing it or not doing it) is what many term “recessionary thinking.”

How do we respond to recessionary thinking? An antidote is “recessionary action.” As consultant Dr. Jim Harris, author of Corporate Excellence: How to Maximize Long-Term Productivity and Profits, says, “Fast and good is better than slow and perfect.” We should all be taking action and working on our businesses.

Specifically, we should be focused on key aspects of our businesses such as sales, cash flow, customer service, systems, and capital spending.
Sales. If competitors have reduced their sales force, it is time to be more outbound and focused on gaining market share. Work hard to maintain, as well as create, relationships with prospects and clients. As an example, during a down market, a lumber distribution business gained market share, maintained profitability, and dampened its own sales decline by aggressively calling on its competitors’ accounts.

Cash flow. Managing cash flow is vital in a recession. Below are three areas on which to focus.

Accounts receivable. During slow times, customers tend to slow down payments, so it is important to stay on top of receivables. I learned a useful trick by trial and error as a young consultant working for a pool supply distribution company. When customers slowed down payments in the 1983-1984 recession, the company consistently called the customers’ accounts payable clerks (not top management) and politely asked to be moved up in their payment queues. The acceleration in cash flow experienced kept the company alive while many others in that business did not survive.

Always keep in mind that managing accounts receivable can be tricky. Remember you are making decisions that will be long remembered by those customers whose businesses persevere through this cycle.

Expenses. Review “habitual” expenses and determine if they are justified. Preserving profitability helps to preserve value in a down economy. You cannot save your way to success; however, you can eliminate some bad habits and preserve or enhance margins. During the recovery from the 1975 recession, we instituted a “doing more with less” mentality at First Tennessee National Corporation. I was in charge of investor relations then and we were trying to retain the confidence of our investors while we worked through massive real estate problems. That year we were successful in reducing operating expenses 15%.

Inventories. It is critical to focus on inventories when sales are declining. Cash flow can be managed by reducing inventories, thereby maintaining reasonable turns on lower sales. Get rid of slow-moving or stale inventory, even if margins suffer. It is better to have the cash than to experience deterioration on the shelves.

Customer service. When business is slow, there is a natural tendency for people to slow down production/projects in order to appear busy. This yields a deterioration in customer service. Do not let this happen. Now is the time to focus intently on timely and quality customer care. Then, when the recovery comes, you will have both satisfied customers and capacity to service new business.

Systems. Every business operates with a variety of systems in sales, operations, manufacturing, distribution, and delivery. Take time, after providing excellent customer service, to evaluate and improve critical systems. At virtually every company, there are at least one or two systems that everyone knows need to be overhauled or tweaked.

“Recessionary action” helps maintain momentum when fighting this headwind of a recession.

Timothy R. Lee, ASA
to participate in
National Center for
Employee Ownership (NCEO)
Teleseminar

“Managing the
ESOP Valuation Process”
September 16, 2009
11:45am - 12:15am (CST)

To register,
visit the NCEO’s website here

For more information on Mercer Capital’s ESOP valuation services, visit our website here
Capital spending. In the December 2008 issue of the Harvard Business Review, Robert S. Kaplan and David P. Norton suggested that senior executives take the time to differentiate between capital expenditures and strategic expenditures, or “Stratex.” So called Stratex items were deemed the last resort when reducing investment. Short term fixes for underperforming capital hardware and systems could be the most expensive solutions if they are made in lieu of incremental investments in positive change. We should be cautious not to emerge from the current recession with yesterday’s solutions.

While it is always a good idea to focus on these areas, it is critical during a recession. “Recessionary action” helps maintain momentum when fighting this headwind of a recession. It also creates the opportunity to potentially gain critical ground on competitors.

We all want this recession to end and it will. The question is where will our businesses be and what will the value be when recovery comes? And what is the value of your business now? Despite the natural aversion we all have to facing the realities of bad economic news, it is vital to understand the value of your business now. You may have a buy-sell agreement whose terms need to be adjusted. It may be time to review life insurance coverage for your buy-sell agreement or for estate planning. It may be a good time to put the incentive stock options that were promised long ago or to sell stock to key employees. With tax law changes currently being contemplated, it may be an ideal time to make gifts of stock.

Interestingly, in the course of assessing value for many clients during this downturn, we have found ourselves challenging clients to envision and project how they are likely to emerge and recover when the economy turns positive again. Most see a gradual and deliberate pace of recovery as opposed to a magical cure springing from deferred investment and pent-up demand. In so doing, many business executives and senior managers are able to anticipate the needs and challenges of providing for a future based on a range of expectations, both operationally and financially. The most basic tenet of business valuation translates future profitability to a present value today. Admittedly, no spreadsheet exercise in and of itself is going to translate to future performance. However, in our experience, envisioning and projecting how you are likely to emerge from the recession can serve as a road map for identifying critical choices to act upon.

Many business owners intellectually understand this a good time to pursue family and business ownership plans, but many, as alluded above, are simply emotionally paralyzed and willing to cocoon for a better day. The problem with inaction is you compound the problems of today by not capitalizing on the opportunities. Every recession in the history of the world has ended. When the recession of 2008-2009 ends, where will you be, and what will be the value of your business?

To discuss a valuation issue in confidence, please call us at 901.685.2120 or you can e-mail me directly at mercerc@mercercapital.com.
An Update on H.R. 436
Certain Estate Tax Relief Act of 2009

In May 2009, the Office of Tax Policy released its “General Explanation of the Administration’s Fiscal Year 2010 Revenue Proposals,” otherwise known as the “2009 Greenbook.” The Greenbook includes the proposed House Bill 436 entitled “Certain Estate Tax Relief Act of 2009.” The proposal would impact gift and estate tax valuations of non-actively traded businesses as follows:

- Disallow all valuation discounts for non-business family entities;
- Disallow minority interest discounts in family-owned business entities; and,
- Continue the estate tax, freezing the exemption amount at $3.5 million and fixing the estate tax rate at 45%.

The AICPA submitted a comment letter to Congress opposing the elimination of valuation discounts for estate and gift tax purposes with respect to non-actively traded businesses for the following reasons:

- Closely held entities are created for a variety of non-tax reasons;
- Discounts are appropriate for fractional interests and are a function of economic reality;
- The proposal in H.R. 436 will result in overvaluation; and,
- The proposal in H.R. 436 will have a negative impact on small business.

The following modifications were suggested:

- Expand the minority interest discount exception;
- Narrow the family attribution rules;
- Clarify and expand the definition of working capital; and,
- Disallow discounts in situations where an individual dies shortly after he or she makes a transfer to a closely held entity (except for accidental death).

While the bill is currently pending, it seems clear that the Obama Administration will act in some way that is likely to increase revenue. Individuals who are considering estate tax planning should be aware of this bill and the potential implications.

For more information or to discuss a valuation issue in confidence, contact us at 901.685.2120 or email me directly at ingallsw@mercercapital.com.
Thinking of Exchanging Underwater Employee Stock Options?

Due to the extended downturn in stock prices, a significant number of employee stock options (ESOs) awarded in the past several years are currently underwater (i.e., have strike prices in excess of the current stock prices). This article discusses some of the concerns related to the exchange of underwater employee stock options and potential avenues to address those concerns.

Value Focus: Insurance Industry 1st Qtr 2009 Published

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Travis W. Harms Serving on Appraisal Foundation Working Group

The Appraisal Foundation is sponsoring working groups to create documents that put forth voluntary best practices to provide guidance related to valuation in financial reporting. The third working group has been formed and the topic is control premiums. Travis W. Harms, CFA, CPA/ABV, senior vice president, has been named to the group as one of five members.

SELECTED LIST OF RECENT & UPCOMING SPEAKING ENGAGEMENTS

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<td>** to register: <a href="http://www.nceo.org/meetings/meeting.php/id/90">www.nceo.org/meetings/meeting.php/id/90</a> **</td>
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<td>October 19, 2009</td>
<td>“So You Want to Be An Expert?”</td>
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To see a complete list, visit the Speaker’s Bureau section of our website at www.mercercapital.com. To inquire about engaging a professional from Mercer Capital to speak to your group, contact Barbara Walters Price at priceb@mercercapital.com, or by calling 901.322.9724.
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Valuation issues intersect with a bank’s affairs more often than you may imagine, and they are likely to arise during your tenure as a director or manager. These valuation issues might include merger and acquisition activity, an employee stock ownership plan, capital planning, litigation, or financial planning, among others. Mercer Capital has been working with financial institutions for over 25 years and has provided valuation and other financial consulting services to thousands of clients. We find that most of our clients have the same basic questions about these important valuation issues. This handbook is written to address many of these questions and to provide useful information for bank directors and managers when valuation needs emerge.

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SECTION THREE: STOCK TRANSACTIONS
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THE BANK DIRECTOR’S VALUATION HANDBOOK
What Every Director Must Know About Valuation
Tagging a text with the label “classic” should not be done carelessly. But 50 years after its initial release, few would disagree that Revenue Ruling 59-60 deserves the title. Written in the spare, unadorned style of a government publication, the Ruling is a compact storehouse of enduring practical wisdom for business appraisers and the users of appraisal reports.

Our purpose in writing this book is twofold: first, to offer a guided tour through the Ruling, pointing out some of the most prominent features of the landscape (and providing the occasional warning about rough terrain); second, to pull back the curtain a bit, granting a non-technical view of how appraisers (at least this group) attempt to translate the guidance found in the Ruling into actual valuation engagements.

Published in January 2009, this 120+ page book is written for attorneys and other users of business appraisal reports. Order your copy today.

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