Reach New Heights!

The Las Vegas ESOP Conference & Trade Show

November 9 -10, 2017

Evaluating Financial Projections as part of the Diligence Process

ESOP™

Preface

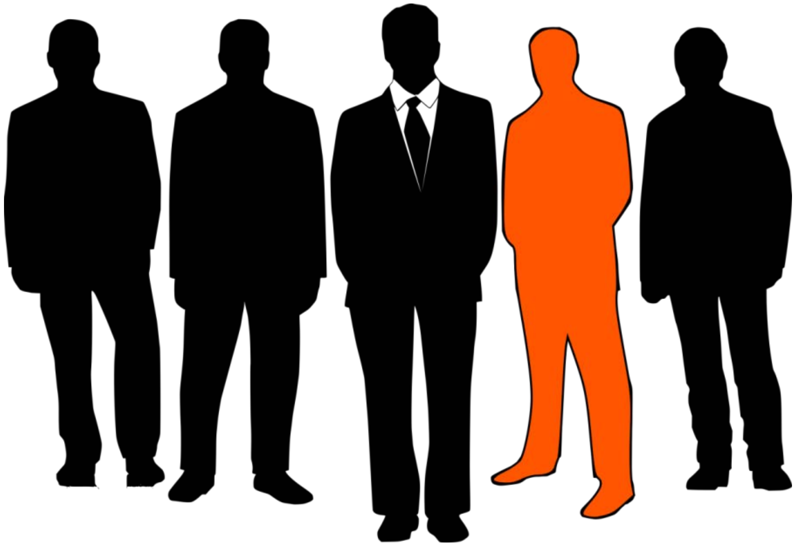
- Please fill out a session evaluation form and drop it off at the table outside of this room
- Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs
- Take a moment to silence your cell phone
- Remember to get your CPE sheet stamped before and after each session for CPE credit

Session Description

Evaluating Financial Projections as Part of the Diligence Process

Management's financial projections are a key input into the analyses underlying ESOP **fairness opinions and annual appraisal reports**. Furthermore, the **DOL Process Agreement** highlighted the importance of thoroughly **evaluating management's financial projections**. This session will review **methods and procedures** that fiduciaries and valuation professionals can use to evaluate the **reasonableness** of projections as part of the valuation process. Furthermore, the panel will address the importance of obtaining sufficient **industry-related information and/or employing outside experts** when dealing with industry-specific nuances. Finally, [the] panel will address the feasibility of a **quality of earnings (Q of E) report**, and what alternatives may be available in connection with the financial due diligence process.

Who cares? Why worry?



- **Lenders**
- **Sellers**
- **Seller’s Advisor**
- **ESOP Trustee**
- **Trustee’s Advisor**

Who cares? Why worry?

Employees / Participants

Regulators / ERISA

Fiduciary Process Agreement

- **Is the agreement case-specific or does it apply to other/all trustees?**
  - "Others in the industry would do well to take notice of the protections put in place by this agreement."

    Phyllis Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration, June 30, 2014, EBSA News Release, U.S. Department of Labor

- **Is the FPA applicable only for transactions or does the "guidance" extend to plan year valuations for ESOPs?**
  - **Selection & oversight of valuation advisor**
  - **Critically assess the reasonableness of any projections**

Foundations & Guiding Concepts

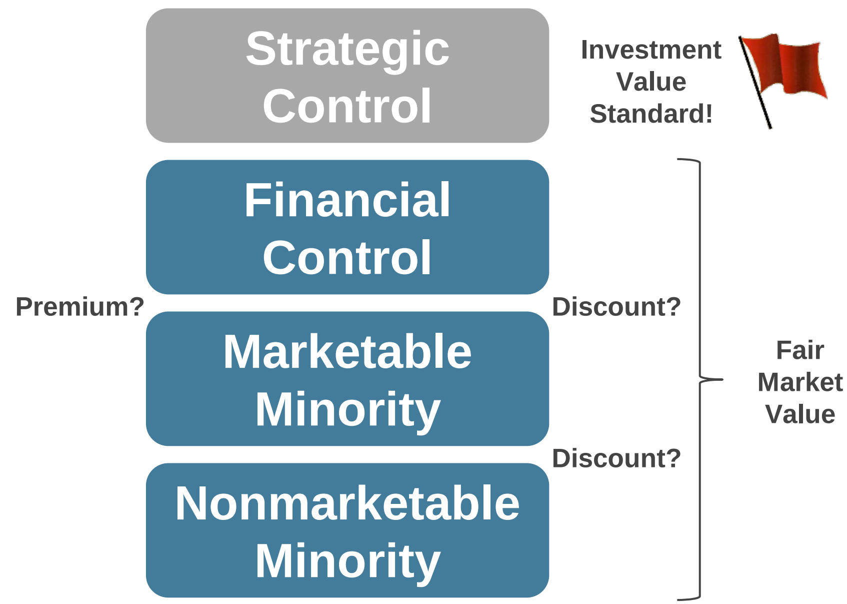
Fair Market Value (Standard)

- a.k.a. "Adequate Consideration"
- Willing buyers & sellers
- Capacity to transact
- No Compulsions
- Well-informed about the asset and its relevant market
- Cash equivalent
- Premise of going concern
- Determined in good faith

Levels of Value

- Potential confusion rising
- "Fair value" market participants

  ≠ fair market value investors



Income Methodology Fundamentals

Single Period Capitalization (SPC)

$$\text{Value} = \text{Cash Flow} \div \underbrace{\text{Capitalization Rate}} = \text{Cash Flow x Multiple}$$

$$\text{CR} = \text{risk} - \text{growth rate}$$

$$\text{Multiple} = 1 \div \text{CR}$$

Discounted Future Benefits (DCF)

$$\text{Value} = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_n}{(1+r)^n} + \frac{SPC_{\text{Terminal}}}{(1+r)^n}$$

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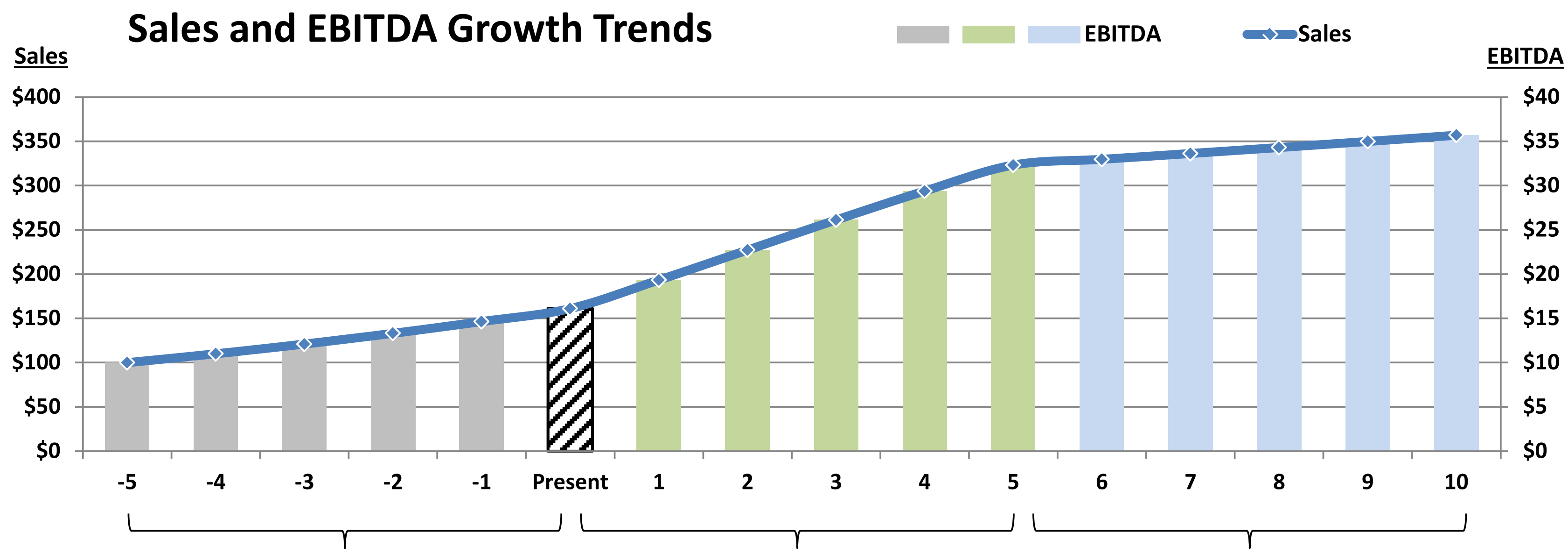
Discrete Projection Employed
Until Cash Flow is Stabilized

Duration of the Discrete Projection?



Historical Five-Year Period of 10% Annual Sales Growth

Five-Year Period of Territory Growth CAG = 15%

Five-Year Period of Maturation CAG = Inflation

Years 6 – 10 Implied by DCF Terminal Period Growth Rate

Projections – The Bad and the *Less Bad*

Cynicism and Devil's Advocacy

More than…
Caveat Emptor

- "Financial projections consistently are the weakest part of business plans"
- "I rarely see a financial plan I can't take apart quickly"
- "No consistent formats"
- "Lack of detail – not bottoms up"
- "Unrealistic and overly optimistic assumptions – especially timing related (revenues, development, schedule, cash flow break even)"
- "Model cannot be easily manipulated (to much hard wiring and not enough assumption-driven)"
- "Omission of costs and balance sheet items" (understates capital requirements)

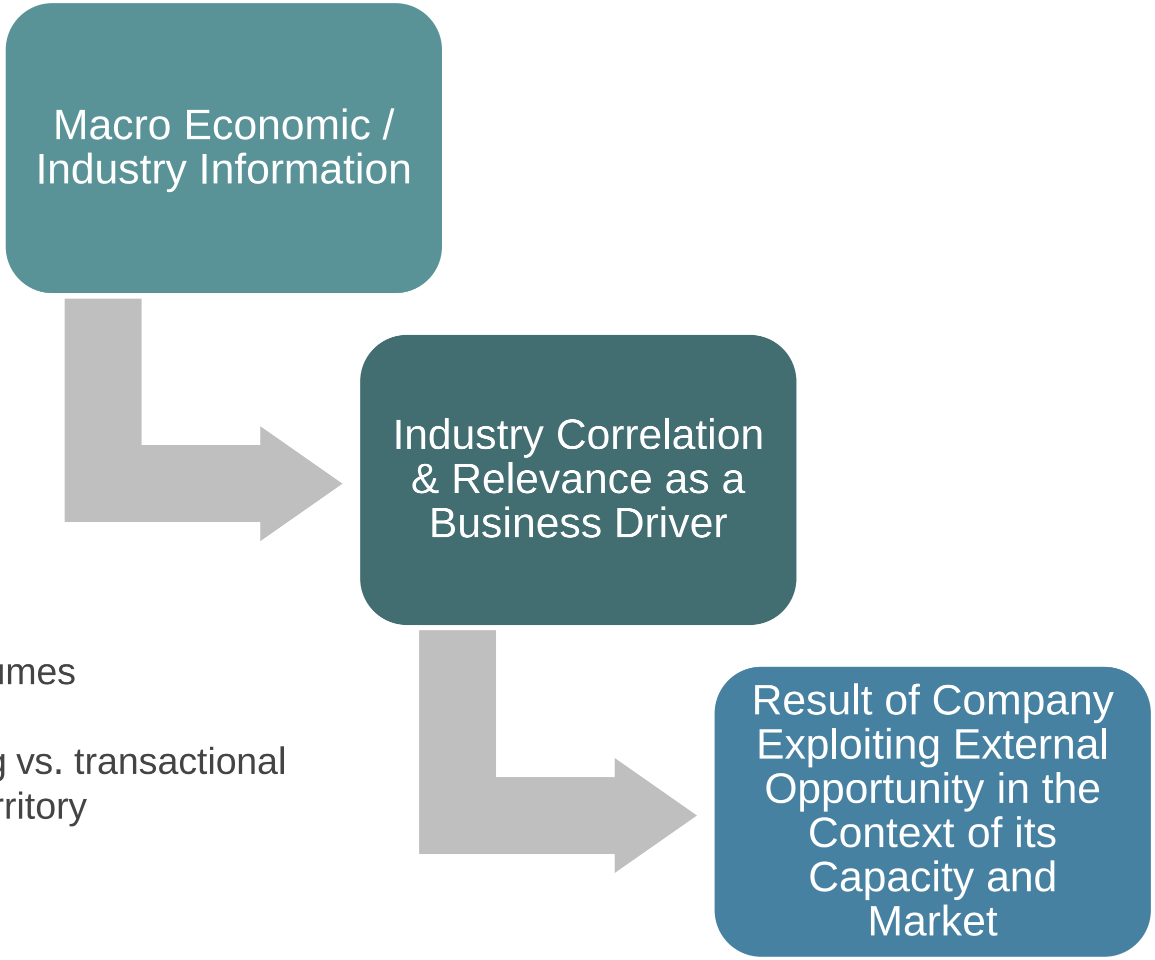
Projections

What a Projection Ought to be…

- Reflection of the business plan
  - Should be consistent with strategy
  - Reveal financial feasibility and identify challenges
  - Indicator of organic and outside financing resources required to execute the plan
- Clearly communicate and connect the quantitative and operational aspects of the business with financial requirements and results (lacking this begs credibility)
- Reconcile key financial ratios to industry / competitor / lender benchmarks

Projections – Organizing Frameworks

A well-crafted projection includes context to the Company's industry and its immediate market



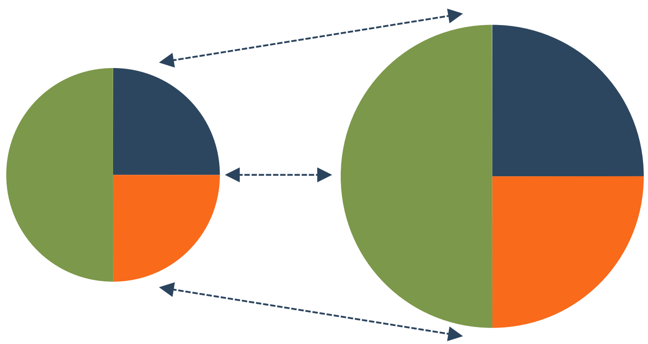
Examples:

- Manufacturing – customer volumes
- Contractors – backlog
- Service businesses – recurring vs. transactional
- Distributors – inventory and territory

Projections – Classic Reminders

Industry Growth

The whole pie is growing



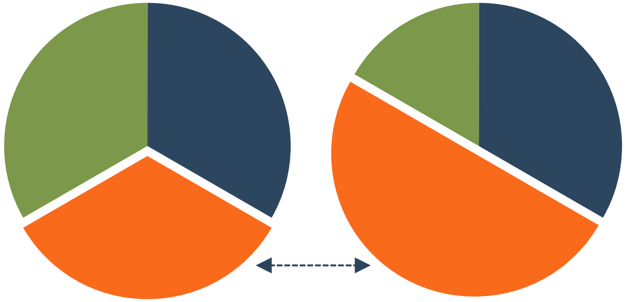
- Are there reliable sources of historic and projected industry growth rates?
- Do the company's projections reflect these industry expectations?
- What makes the company different from the industry?
- Does the company have the resources available to invest for growth that matches or exceeds the industry?
- What if the industry is in a state of decline?
- What is the dynamic between industry and economic conditions?
- Is share rebalancing with winners and losers? Risk of masking underlying issues

Gravity works = mean regression: an industry (or niche) that is growing rapidly will eventually slow to a pace more similar to the growth of the overall economy.

Projections – Classic Reminders

Market Share Growth

Bigger piece of the pie

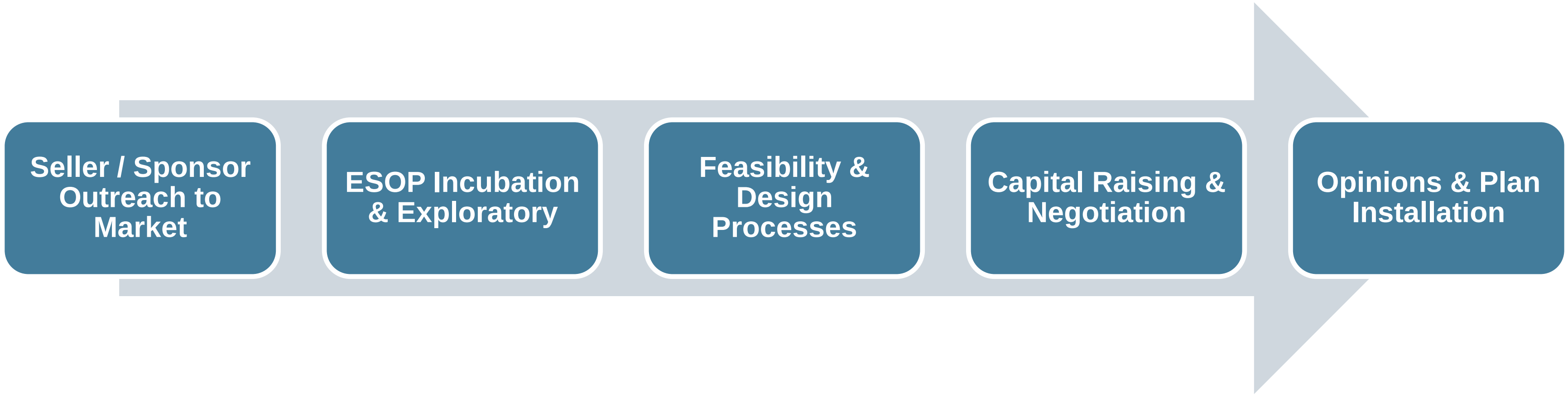


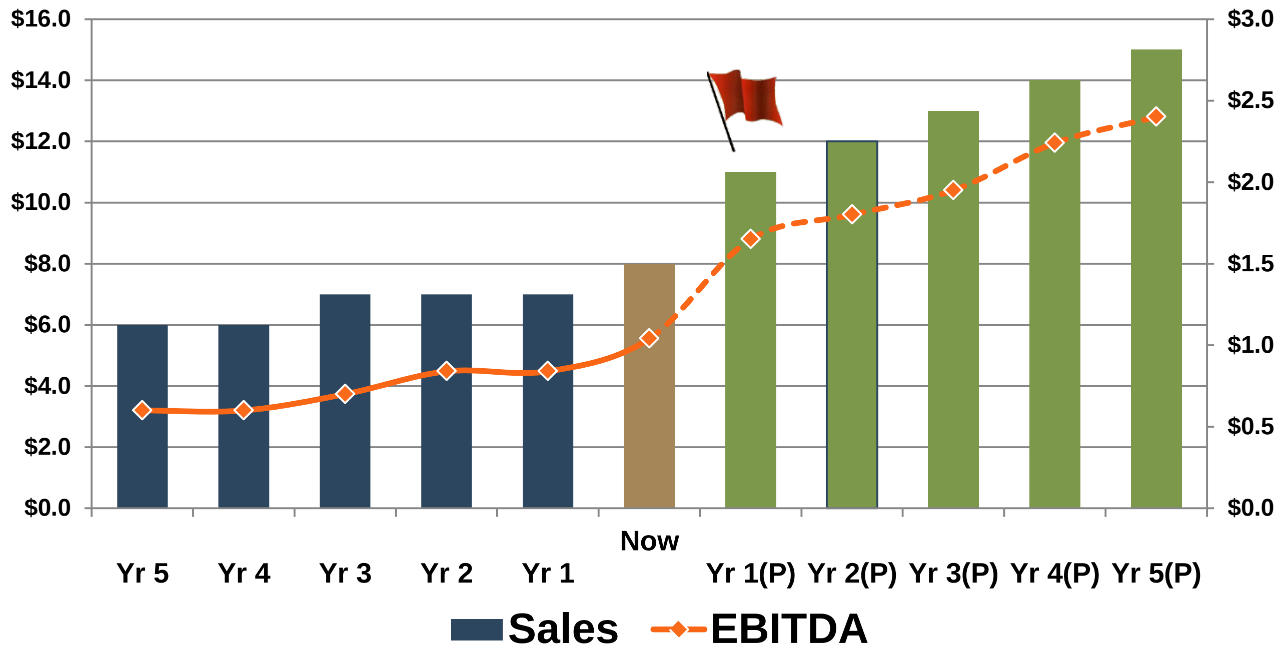
- Is there opportunity to expand market share?
- Does the company have a track record of increasing market share?
- What is the basis for competition in the industry? (price, quality, service, etc.)
- Can the company outpace the competition in the important areas?
- How do you forecast if the company has been losing market share?
- Who are the winners and losers and why?

The size of a market is generally finite, so a company cannot increase market share forever

Share growth and consolidation in otherwise non-growing industries can be a predicate for future decline or disruption

Projections – Source? Purpose? Timing?





Projections – Before the Numbers

- Who prepared the projections?
  - Top-down process of CFO
  - Bottom-up process from frontline managers, assembled and tweaked by CFO
  - Projections vetted and approved by board or management committee?
- What is the functional purpose of the projections?
  - Sales goals
  - Budgeting
  - Annual line of credit negotiations
  - Other third party reliance?
  - ESOP Sale
- How experienced is the Company preparing projections?
  - Ongoing tracking of variances between actual and projected
  - Annual lookback and reconciliation with summary of factors underlying actual results
  - Operational segmentation and analysis could suggest degree of internal reliance
  - Projections updated during the year?
- When were the projections prepared?
  - Known or reasonably knowable standard used for valuation
  - Timing and changes relative to valuation process (“material or subsequent changes”)

Projections – Big Picture Before the Details

- Are the financial projections reconciled to or generated from a meaningful expression of unit volume and pricing?
- Does the company operate as the exclusive or concentrated agent for certain suppliers and/or customers?
- How does the company's current projection reconcile to past projections? How closely does the company's most recent actual performance compared to the prior year's projection?
- Does the projection depict a transition in industry or economic cycles that may justify near-term abrupt shifts in expected outcomes?
- Do the projections incorporate increased (new) business, and if so, in what manner is the new business being generated?
  - New and/or discontinued business = pro forma
  - Corresponding investments in working capital and capital assets?
  - History of business additions both organically and strategically?
  - When does new business count in the valuation?

Projections – Details Matter

Sum of & Product of the Parts

Revenue and Costs

Is the topline and the cost structure of the projection driven by the same analytical segmentation used to analyze the Company's industry and/or operations and/or production inputs and outputs?

Has the appraiser replicated the projection model to capture the relevant operational aspects of the business?

Revenue	**=**	**Volume**	**x**	**Selling Price**
Cost	**=**	**Volume**	**x**	**Purchase Price**
		Volume in Units of Service or Production		Costs in Units of Service or Production

Examples:
Product category, location, weight, unit count, hours, etc.

Projections – Details Matter

Sum of & Product of the Parts

Operating Expenses

Is the expense base segregated by major category and/or grouped by fixed and marginal expenses?

This provides potentially significant insight into the operating leverage of the business.

How do major elements and the overall projection reconcile to past measures?

Do vital aspects of the projection reconcile to external measures from peers in the market place (trades and publics, bell weathers)?

Any perspective on breakeven levels of operating and financial performance?

Projections: Influence on Transaction Structuring

Debt Capacity

- Reasonable projections with solid support will improve credibility and enhance Company's debt capacity
- Debt capacity plays an important role for not only cash at close for sellers, but also on-going operating and growth needs of the business
- Lenders typically set their covenants based on management's projections

Repayment of Debt

- Company's financial advisor should construct a cash flow model to make sure management's projections can support debt service AND business on-going needs
- Timeframe of debt repayment is critical in structuring the terms of outside debt AND seller financing
- Repayment schedule also impacts seller financing returns, which may include warrants

Projections: Influence on Transaction Structuring

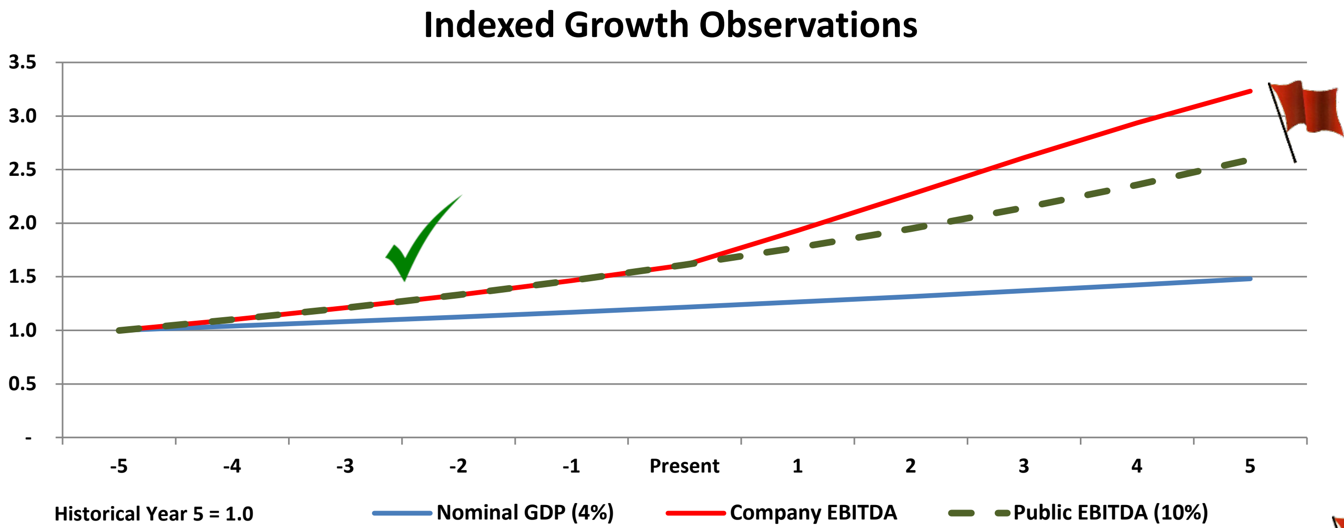
Post-Closing Tax Planning

- Company financial advisors should assist management and its tax advisor to estimate and to plan for post-closing taxes (exception – 100% S-Corp ESOPs)
- For C-Corp ESOPs, tax strategies tend to involve acceleration of ESOP contributions and/or dividends
- A good projection is the first step to plan for tax savings and potentially accelerated repurchase obligations

Post-Closing Employee Benefits

- Advisors should assist management in estimating employee benefit levels under ESOP, which is a function of (i) projected ESOP contributions/ dividends, (ii) projected payroll; and (iii) projected share value post-closing
- Issuance of SARs to key executives is typically tied to achievement of projections
- Over/under compensating through ESOP negatively affects long-term sustainability of business after ESOP

Projections: Sanity and Reasonableness



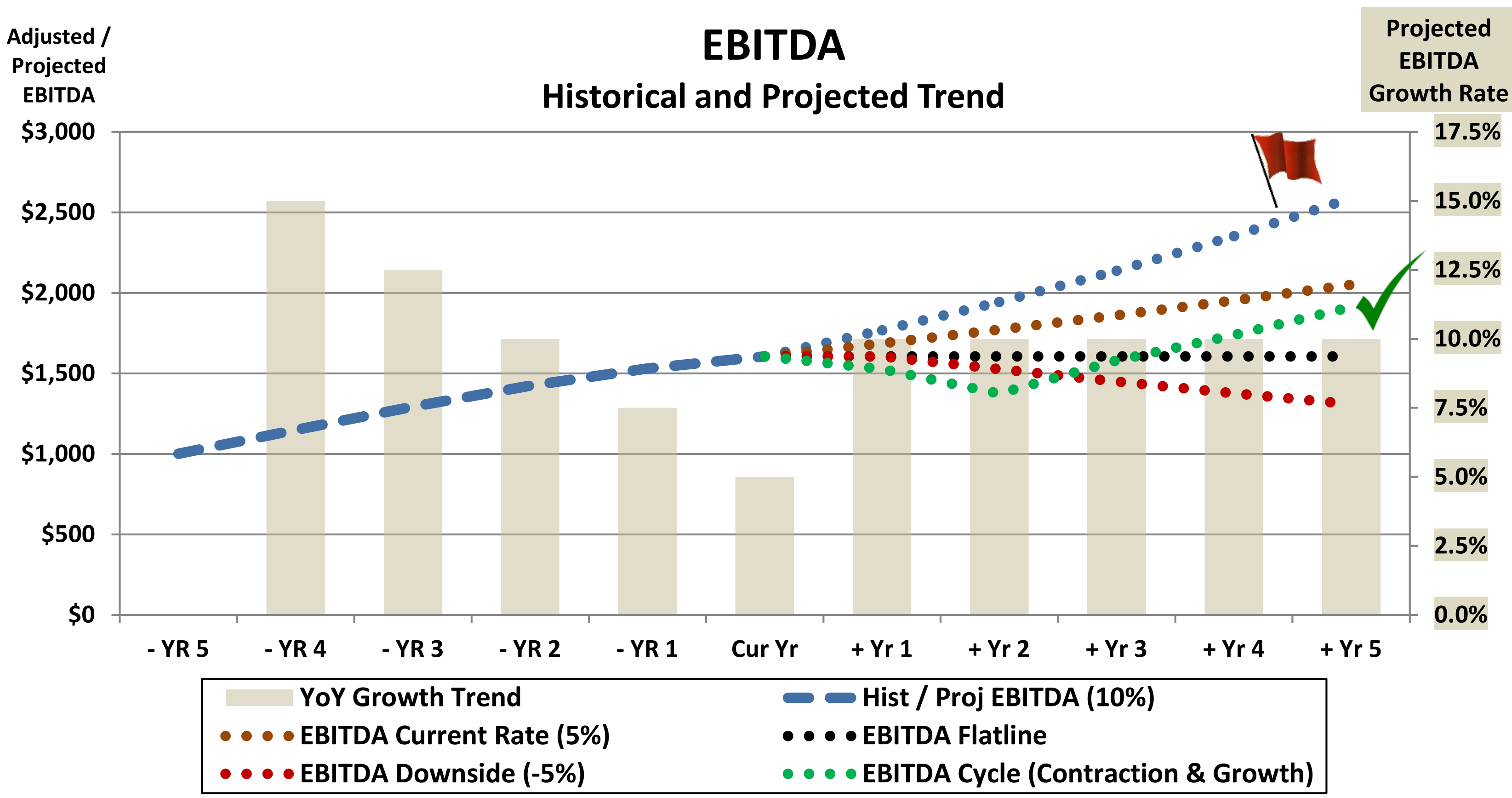
Subject Company Reconciliation

- Historical Growth of Subject
- Trends & Expectations of Industry Peers & Public Comps
- Working Capital and Capital Investment (no free lunch)
- National and Regional Economics

Projection & DCF Concerns

- Projection Growth > History
- Contrary to Economics
- Working Capital and Capital Expenditures not Tracking Growth
- Terminal Depreciation > CapEx
- Elevated Terminal Growth
- Market Data in the Terminal Period? Impact on Growth?

Projections: Stress Testing & Alternatives



Projections: Caveats and Disconnects

An aggressive forecast isn't always unreasonable

- An unreasonable forecast is never a good idea
- Verification of objectives and whether the forecast is achievable
- Inclusion of sufficient working capital and capital expenditures
- Detailed analysis of the financial metrics and achievements
- Requires significant input from management
- Determine whether additional cash or debt is necessary to achieve forecasts
- Error input in excel or data entry
- Rethinking aggressiveness of growth, etc.

Adjustments can be applied based on the Valuation Advisor's judgement

- Income and cash flow forecasts
- Discount rate – *likely better to revise or adjust the projection*
- Discount for lack of marketability

Projections: Techniques for Addressing

Discounted Future Benefits (DCF)

$$\text{Value} = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_n}{(1+r)^n} + \frac{CF_n\,(1+g)}{(1+r)^n}$$

Projections: Techniques for Addressing

Discounted Future Benefits (DCF)

% Adjust Terminal Growth Rate %

$ Revise Cash Flows $

$$\text{Value} = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_n}{(1+r)^n} + \frac{CF_n\,(1+g)}{(1+r)^n}$$

% Assess Risk in Context of Projection and Fundamentals %

Projections: Non-DCF Collateral

- Selection of, adjustment of, and application of publicly traded guideline companies
  - Relative Risk Assessment
  - Relative Growth Assessment
  - Relative Margin Assessment
- Selection of, adjustment of, and application of guideline transaction data
  - Relative Risk Assessment
  - Relative Growth Assessment
  - Relative Margin Assessment
- Organization of reporting content and analysis
- Transaction structuring and financing

Quality of Earnings Report

What is it?

- Independent verification and documentation of facts and circumstances underlying a company's sales and profitability
- Reconciliation of differences between reported figures and figures employed in valuation (substantiation of adjustments and pro forma)
- Forensic in nature but includes assessment of projections
- Accuracy and sustainability of historical earnings, and achievability of projected earnings

Who requisitions it?

- Typically requisitioned by the buyer in a transaction as part of the diligence investigation of the seller's information
- Increasingly required by financial investors – outgrowth of capital underwriting processes

Content and Scope

- No formal standards or structural guidance
- Can include assessment of strategic plan and business execution (go-to-market) plans
- Focus is top-to-bottom segmentation analysis (sales, costs, expenses)
- Identification of business drivers
- Impact of identifiable intangibles
- Identification and examination of concentrations and contingencies (management, what-if analysis and stress testing)
- Risk and opportunity assessment (economic, industry, company-specific)

Take-Aways

- The projected financial outcomes of a company must be based in reality, with respect to a company's operational capacity, product/service demand, and market participants.
- Forecasts do not exist in a vacuum; they must be constructed in conjunction with industry specific realities and the overall economy.
- The valuation report should correlate the assumptions of the financial forecast to the relevant aspects of the economic and industry drivers.
- Be of aware of potential bias or myopathy: forecasts that are too optimistic, or those prepared by management who participate in the ESOP or who are granted equity-based compensation.

Take-Aways

- A valuation report must contain a thorough discussion of the past, present, and future financial performance of the subject company.
- The valuation report should describe the financial performance of the subject company in relation to its value metrics: revenue growth, margin and profitability analysis, leverage, working capital requirements, and capital structure.
- Forecasts must be defendable. Hence, the in depth analysis and discussion of the information with management and decision-makers.

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Postscript

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