MERCER CAPITAL
5860 Ridgeway Center Pkwy,
Suite 400
Memphis, TN 38120
901.685.2120 (P)
901.685.2199 (F)

www.mercercapital.com

**MERCER CAPITAL**

# Understand the Value of Your Local Exchange Carrier

by Laura J. Hoffmeister

Laura J. Hoffmeister 901.322.9764 » hoffmeisterl@mercercapital.com

Laura Hoffmeister is currently a senior financial analyst with Mercer Capital. Mercer Capital is a premier business valuation and investment banking firm serving a national and international clientele.

Business valuation services are provided for a wide variety of needs, including but not limited to corporate valuation services, tax compliance, litigation support, financial statement reporting compliance, and employee stock ownership plans. Clients range from public to private, from smaller companies to large multi-nationals in a broad range of industries as well as numerous governmental agencies.

In addition, Mercer Capital provides investment banking and corporate advisory services including sell-side and buy-side merger & acquisition representation, fairness opinions, solvency opinions, business interest and securities valuation, and board presentations, among others.

Circumstances giving rise to the engagements Ms. Hoffmeister is involved with include corporate planning, employee stock ownership plans, and estate and gift tax planning and compliance matters.

## About Mercer Capital

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Mercer Capital is an employee-owned independent financial advisory firm. We have experience in a broad range of industries, including, but not limited to, automotive, consumer products, distribution, energy, financial services, health care, industrial products, media and entertainment, pharmaceuticals, technology, telecommunications and utilities.

For twenty-five years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world. Rely upon the expertise, experience, reputation and critical thinking of Mercer Capital.

# Understand the Value of Your Local Exchange Carrier

**Laura J. Hoffmeister**
*hoffmeisterl@mercercapital.com*

Over the past decade, the telecommunications industry has been characterized by rapid innovation accompanied by the obsolescence that often follows rapid innovation. Companies have essentially been forced to operate in a "spend to keep up, or get left behind" atmosphere. For Incumbent Local Exchange Carriers (ILECs) and Competitive Local Exchange Carriers (CLECs), this has posed a particularly difficult challenge, as their product offerings are quickly becoming archaic in the new fast paced world of global wireless service and streaming video. Regardless of how you choose to deal with the ever changing competitive environment – be it through selling, acquiring, divesting, or any other major strategic change – it is important to realize the value of your telecommunications company as it stands today. Without knowing this critical piece of information, it will be virtually impossible to make an informed decision regarding the future of your company. Even if you decide not to consider one of the options listed above, eventually the ownership of your business will change hands. You can't afford to be unprepared.

## THE BUSINESS TRANSFER MATRIX

Above, we introduced the concept that all business ownership will eventually be transferred. At Mercer Capital, we developed the Business Transfer Matrix to illustrate the universe of ownership transition scenarios. As depicted below, these scenarios range from voluntary transfers such as gifts to family members or an outright sale to a third party to involuntary transfers such as those precipitated by death or divorce. Our essential point is worth reiterating: an understanding of the value of your business or business interest is a critical element in preparing yourself for any of these eventualities.

| OWNERSHIP TRANSFER MATRIX | Partial Sale/Transfer | Total Sale/Transfer |
|---|---|---|
| **Voluntary Transfers** | ESOP<br>Outside Investor(s)<br>Sales to Insiders/Relatives<br>Combination Merger/Cash Out<br>Going Public<br>Gifting Programs<br>Buy-Sell Agreements | Sale of Business<br>Stock-For-Stock Exchange<br>w/Public Company<br>Stock Cash Sale to Public Company<br>Installment Sale to Relatives/Insiders<br>ESOP Management/Buyout<br>Buy-Sell Agreements |
| **Involuntary Transfers** | Divorce<br>Forced Restructuring<br>Shareholder Disputes<br>Buy-Sell Agreements | Death<br>Divorce<br>Forced Restructuring<br>Bankruptcy<br>Shareholder Disputes<br>Buy-Sell Agreements |

## BACKGROUND CONCEPTS OF "VALUE"

Before covering some specific details related to the telecommunications industry, it is important to understand some basic concepts related to valuation analysis.

It comes as a surprise to many business owners to learn that there is not a single value for their business. Numerous factors (legal, tax or otherwise) play important roles in defining value based upon the circumstances of the transfer of equity ownership. While there are significant nuances to each of the following topics, our purpose here is to help you combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary).

*Valuation Date*

Every valuation has an "as of date" which simply means that it is the date around which the analysis is focused. The date may be set by legal requirements related to a death or divorce, or be implicit, such as the closing date of a transaction.

*Purpose*

The purpose of the valuation is important because it is linked to the transfer event (such as a sale, estate planning, etc.). A valuation prepared for one purpose is not necessarily useful for another.

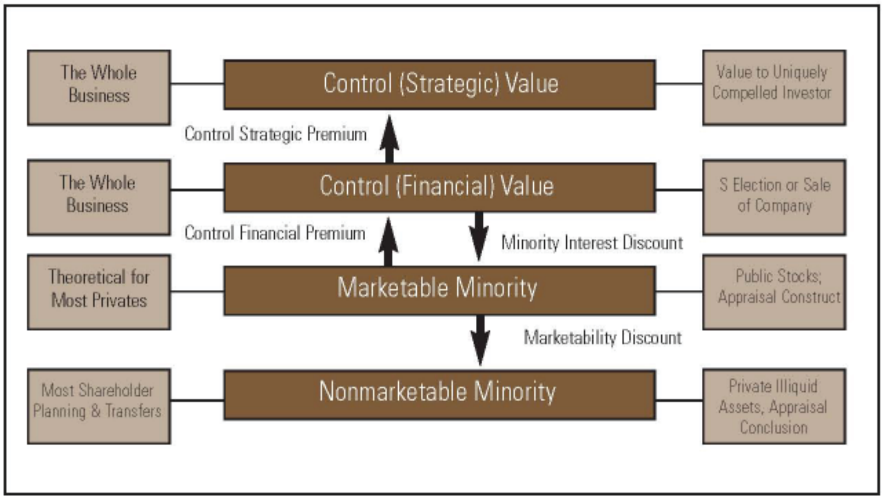
*Standard of Value*

The standard of value is an important legal concept, which must be addressed in every valuation assignment. Fair market value, which is most commonly used in tax matters, is the most familiar. Other important standards are investment value (purchase and sale transactions), statutory fair value (corporate reorganizations), and intrinsic value (public securities analysis). Using the proper standard of value is crucial in obtaining an accurate determination of value. There are many standards of value just as there are many types of ownership transfers. The standard of value will influence the selection of valuation methods and the level of value.

*Levels (Premise) of Value*

When business owners think about the value of their business, they are almost always implicitly thinking about the value of the business in its entirety. The value of a single share, for example, is the value of the whole divided by the number of shares. In the world of valuation, this may not be true if the block of stock under consideration does not have control of the enterprise. The determination of whether the valuation should be on a controlling interest or minority interest basis can be a complex question, yet it is of great importance. A minority interest value can include discounts for the lack of control and marketability, therefore, it is quite possible for a share of stock valued as a minority interest to be worth far less than a share valued as part of a control block.

The following chart presents the concept graphically.




A lack of basic knowledge about these issues will leave you short of the required vocabulary and understanding needed to comprehend the context with which the value of a business interest is developed.

## INDUSTRY CONDITIONS

In order to arrive at a credible value for an ILEC or CLEC it is important to understand current conditions in the industry.

*The Rise of Wireless*

Except for those among us who have been living under a rock for the past ten years, it is obvious that wireless phones are replacing traditional wireline service at an unprecedented rate. Landline revenue has decreased nationwide, while wireless revenue has continued to grow at double-digit rates. To no one is this more obvious than a local exchange carrier operator. As consumers abandon “home” phones for mobile phones as their only telephone service, landline telephone companies have had to struggle with how to survive. While the situation is far from crisis proportions (wireless in the commercial market, for example, seems a bit more distant) one is inclined to believe that eventually wireline phones could cease to exist.

*The Disappearance of Pure Play Operators*

In response to the issues detailed above, many telephone companies have begun to diversify their service offerings. Some have invested in local or regional wireless providers as a hedge to the business lost to wireless service. Others have taken the more capital intensive and strategically challenging approach of adding one or more of cable, internet, Voice Over Internet Protocol (VOIP), or wireless services. While these business lines offer growth and expansion opportunities, telephone companies are forced to operate in unfamiliar waters and compete with more seasoned players. Wireline carriers are not the only ones playing this game. Internet and cable companies are also offering “bundles” of the services listed above. Only time will tell which side will win out and earn the right to provide consumers with the majority of their communication and media needs.

*Regulators*

Although the telephone industry went through deregulation in the 1980s with the dismantling of "Ma Bell," the industry as it stands today is anything but deregulated. The ability of carriers to increase rates is extremely limited, requiring approval by several regulatory bodies – approval which is rarely given. Were it not for the Universal Service Fund (USF), the depressed rate structure under which most ILECs and CLECs are forced to operate would cause most of these companies to report significant operating losses. But the future of USF payments is uncertain. Political battles regarding the payments have been fought in Washington, D.C. for years now. Despite recent reforms, it is still anyone's guess as to how long these payments will continue, to whom, and in what amount.

## FINANCIAL CONSIDERATIONS

*The Balance Sheet*

The typical balance sheet of an ILEC or CLEC is characterized by a large concentration in fixed assets (often heavily depreciated) and to a lesser extent accounts receivable. While it is appropriate in many valuations to consider the market value of certain fixed assets, the nature of the assets held by telephone companies diminishes the importance of this exercise. The ever-changing technology in the industry contributes to a rapid decline in the market value of existing technology, sometimes even more rapid than accounted for through aggressive depreciation. Additionally, the fixed assets held by a telephone company are often quite literally just that – fixed. Networks of wire buried in the ground or strung through the air are seldom useful to another entity, except perhaps a potential purchaser of the company as a whole.

While accounts receivable may represent a concentration on the balance sheet, the receivables themselves are highly diversified due to the number of customers relative to the size of the average bill. For this reason, it is rarely necessary to consider an adjustment to market value for accounts receivable.

In the case of companies that have invested in regional wireless carriers, those investments are generally carried on the company's balance sheet at cost. Depending on when the investment was made, and the performance of the wireless carrier since the initial investment, it may be necessary in an appraisal to mark the investment to market value. In many cases, the wireless company itself is also private, requiring additional appraisal work to determine an appropriate market value.

*The Income Statement*

Telephone companies generally report relatively steady earnings streams, heavy depreciation expense, and, in recent years, often report slowly declining revenue. Because industry conditions are changing so rapidly, and particularly in cases where earnings and/or revenue are declining, it is generally appropriate to consider performance in only the most recent years. Operating expenses are usually fairly stable, often increasing modestly at the approximate rate of inflation. The capital expenditures made by telephone companies consist primarily of purchasing and updating equipment that requires few or no additional personnel to operate, and therefore generally cause only minimal corresponding increases in operating expense.

The high level of depreciation expense related to the concentration of fixed assets on the balance sheet makes EBITDA a particularly important metric in valuing a telephone company. While valuations can be developed based on multiples of net income, EBIT, and revenue, EBITDA provides a powerful test of reasonableness in any valuation of an ILEC or CLEC. There are many subjective accounting assumptions that go into the calculation of depreciation and amortization. Ultimately it is real cash flows (depreciation and amortization are non-cash charges) that create value for a business.

## APPROACHES TO VALUE

There are three general approaches to valuing a business – asset-based, income and market. Specific applications of these approaches are called "valuation methods." As a general rule, every valuation should address value using these approaches. Each approach incorporates procedures which may enhance awareness about specific business attributes that may be relevant to determining the final value. Ultimately, the concluded valuation will reflect consideration of one or more of these approaches (and perhaps several underlying methods) as being indicative of value for the subject interest under consideration.

*Asset-based Approach*

The asset-based approach can be applied in different ways, but in general it represents the market value of a company's assets minus the market value of its liabilities. The method applied most often by Mercer Capital is the net asset value method, and involves adjusting the reported value of tangible assets and liabilities to their estimated fair market values.

As mentioned before, the nature of a telephone company's fixed assets makes it particularly difficult to determine a credible market value of those assets. Additionally, the sole purpose of the assets is to generate a stream of income to the company and its investors. Considering the return provided by these assets only serves to convert the asset-based approach into an income approach. In that case, one might as well use an appropriate income method. For these reasons, the asset-based approach is often not used, or is at least used in conjunction with several other methods, in valuing local exchange carriers.

*Income Approach*

There are various ways to apply the income approach. In general, the income approach provides a way of determining a value by converting anticipated economic benefits into a present single amount. The two most common examples of an income approach are the discounted future benefits method and a single period capitalization of income. Given that a telephone company basically consists of a large amount of fixed assets held to generate a stream of income, the income approach can be useful in determining the value of an ILEC or CLEC. Additionally, through the discount and growth rates used, it is possible to control for company-specific factors, such as declining market population, high levels of debt, or successful new service offerings.

*Market Approach*

Market methods include a variety that compare the subject with transactions involving similar interests, including publicly traded guideline companies and sales involving controlling interest in public or private guidelines. Consideration of prior transactions in interests of a valuation subject is also a method under the market approach.

There is no shortage of public companies in the telecommunications industry. However, the comparability of such companies to a local exchange carrier can be questionable. The public arena is dominated by such giants as AT&T, Sprint Nextel, Qwest Communications, and Verizon. To compare a local telephone company to such behemoths with market capitalizations of tens and hundreds of billions of dollars takes more than a little subjective adjustment. Additionally, these companies provide a vast range of services beyond traditional wireline service (internet, wireless, cable, etc.), further calling into question their comparability. Even the smaller publicly traded ILECs and CLECs, which until recent years had provided fairly useful comparisons, have begun branching into other lines of business in order to remain competitive.

Despite these shortfalls, the market approach is still quite useful in valuing a telephone company. As long as the analyst is diligent about rigorously screening the guideline companies for comparability and interpreting and adjusting for any inevitable differences, the multiples indicated by a group of guideline companies can be extremely helpful in reaching a reasonable conclusion of value.

*Pulling It All Together*

A valuation analysis will likely take into consideration all three of the approaches mentioned above. However, the ultimate conclusion of value will generally be based predominately, if not solely, on various measures of value provided by earnings. Market multiples applied to revenue, net income, EBIT and EBITDA are most helpful in providing the perspective of a "market participant." However, an income approach, whether a single period capitalization model or a discounted future benefits model, can supplement the market approach well and provide a sound check of reasonableness. Ultimately, all of the values calculated by the appraiser through different methods and approaches should be viewed in context and used to determine a soundly reasoned and defensible valuation.

## CONCLUSION

Mercer Capital has long promoted the concept of managing your business as if it were being prepared to sell. In this fashion you promote the efficiencies, goals, and disciplines that will maximize your value. Despite attempts to homogenize value through the use of simplistic rules of thumb, our experience is that each valuation is truly unique given the purpose for the valuation and the characteristics of the business.

Mercer Capital has experience valuing businesses across the telecommunications industry, and specifically local wireline service providers. We hope this information, which admittedly only scratches the surface, helps you better shop for business valuation services and understand valuation mechanics. We encourage you to extend your business planning dialogue to include valuation – because sooner or later a valuation is going to happen. Proactive planning and valuation services can alleviate the potential for a negative surprise which could make worse an already stressful time in your personal and business life. Perhaps Yogi Berra wasn't specifically commenting on valuation, but his advice is nonetheless sage: "You got to be careful if you don't know where you're going, because you might not get there."

**Laura J. Hoffmeister**
hoffmeisterl@mercercapital.com

# Mercer Capital At A Glance

**CREDIBILITY**

95% + recurring client retention rate

**EXPERIENCE**

Over 6,500 engagements in hundreds of industries

**SAFETY**

Firm is over 25 years old and growing

**MERCER CAPITAL**

Because Value Matters

Mercer Capital is a leading employee-owned independent financial advisory firm, offering a broad range of consulting and investment banking services, including financial reporting and tax valuation, M&A advisory, fairness and solvency opinions, ESOP and ERISA valuation services, and litigation support.

For over 25 years Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world. Rely upon the expertise, experience, reputation and critical thinking of Mercer Capital.

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  - Goodwill impairment analysis
  - Employee stock option valuation
  - Restricted stock option valuation
  - Intangible asset valuation
  - Portfolio investment valuation
- Employee Stock Ownership Plans
  - Annual appraisals for plan trustees
  - Financial advisory services for plan trustees
  - Security design and equity allocation
  - Fairness opinions
- Tax Compliance Services
  - Estate tax valuation
  - Limited partnership valuation
  - Minority interest, marketability, blockage, and other discounts
  - Valuation for charitable gifts of closely held securities
- Litigation Support Services
  - Business damages
  - Buy-sell agreements
  - Securities fraud analyses
  - Family law and marital dissolution
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  - Close the deal
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  - Business interest and securities valuation
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**HEADQUARTERS**
5860 Ridgeway Center Pkwy,
Suite 400,
Memphis, Tennessee 38120
901.685.2120 (P)
901.685.2199 (F)

**LOUISVILLE OFFICE**
511 South 5th Street,
Suite 206,
Louisville, Kentucky 40202
502. 585.6340 (P)
502. 585.6345 (F)

**www.mercercapital.com**