Evaluating & Analyzing

Financial Projections

in ESOP Transactions and Valuations

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Agenda

- Projections – why worry, who cares?
- What is a projection?
- Single Period Capitalization Method vs. Discounted Cash Flow Method
- Stress testing a projection
- Qualitative and quantitative due diligence considerations

The Fiduciary Process Agreement

Sierra Aluminum DOL / GreatBanc Settlement

- **Does the agreement only apply to GreatBanc?**
  - 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
  - Response of the valuation community perceived as generally favorable by DOL
- **Only applies to purchase or sale of employer securities by ESOP**
  - FPA specifically worded in the context of transactions, but…
  - Many valuation firms and trustees using the FPA as guidance for plan year valuations as well

The Fiduciary Process Agreement

Major aspects of the FPA

- **Selection of Valuation Advisor**
- **Oversight of Valuation Advisor**
- **<u>Fiduciary Review Process</u> including**
  - Critically assess the reasonableness of any projections

Today we will discuss the financial projections

Critical Assessment of the Projections

- **Analysis of the Company's strengths and weaknesses**
- **Ability of the Company to service proposed transaction debt while not impairing the Company’s ability to fund operations and achieve projected growth**
- **Projections of the Company's future economic performance**
- **Compare projections to**
  - The Company's five-year historical averages
  - The five-year historical averages and/or medians of a group of comparable public companies

Document Comparison of Critical Metrics

- Return on assets
- Return on equity
- EBIT margins (earnings before interest and income taxes)
- EBITDA margins (earnings before interest, income taxes, depreciation and amortization)
- Ratio of capital expenditures to sales
- Revenue growth rate
- Ratio of free cash flows (of the enterprise) to sales

Document Comparison of Critical Metrics

- "Particularly management projections…"
- Documentation explaining why and to what extent the projections are or are not reasonable
- What documentation is available?
  - Consider retaining a CPA firm for a Quality of Earnings analysis
    - A deep dive into the financial statements to understand where value is generated by the business
    - Typical in merger & acquisition deals, why not ESOP deals?

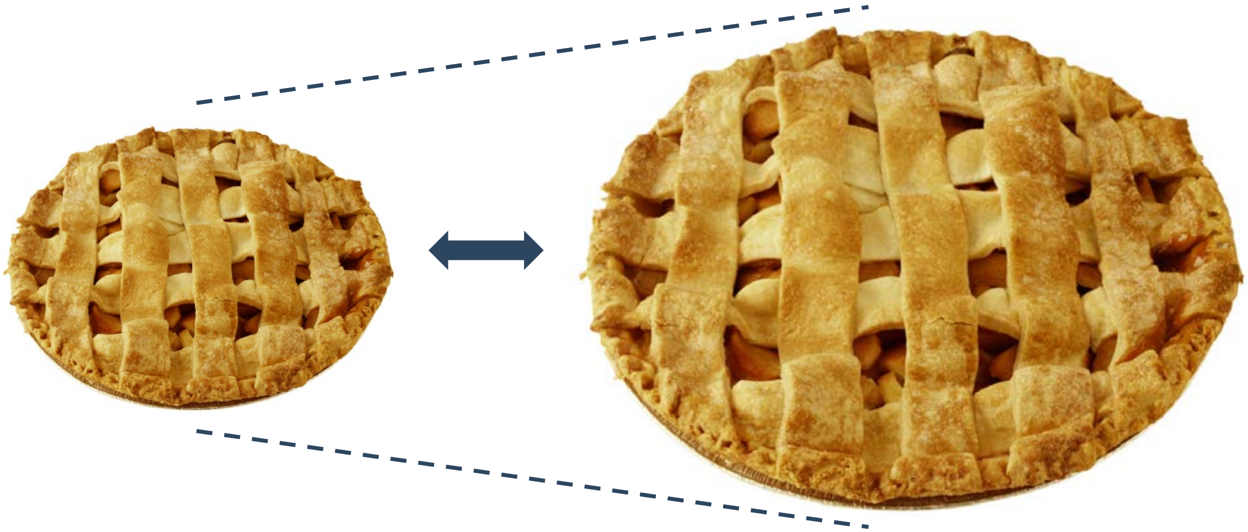
Primer on Projections

- **Do we include what is in well crafted projections?**
  - Consistency of gross margin, current assets to sales, net working capital
  - CAPEX & depreciation
  - Normalized retirement benefits
  - Adjustments for shareholder compensation, etc.
  - Debt restructuring

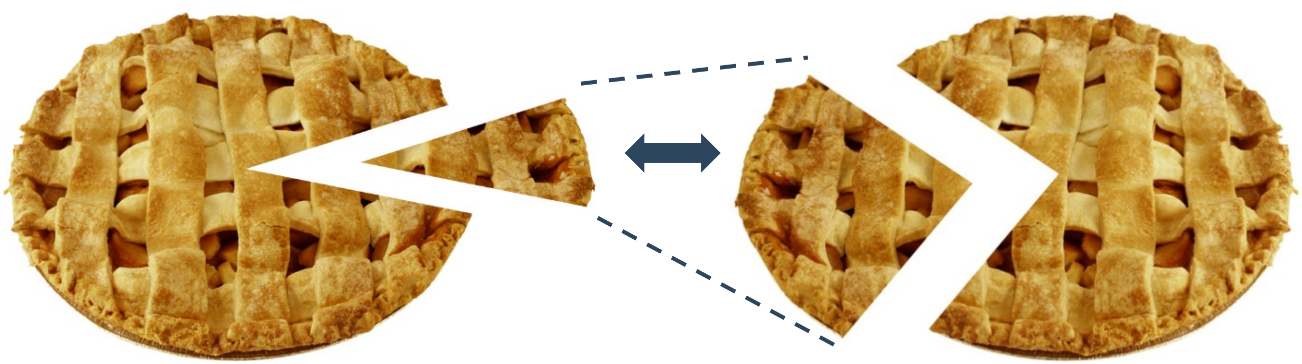
Sample Quality of Earnings Findings

- Insufficient supporting documentation for adjustments to EBITDA
- Changes with key customers, such as churn or pricing
- Issues related to inventory valuation
- Significant changes in reserves between periods or a lack thereof
- Where amounts are recorded in the financial statement from operating to non-operating (“Geography issues”)
- Inaccurate capitalization policies for fixed assets
- Inconsistent application or changes in accounting policies or procedures between periods

Where is growth coming from?



and / or



Industry Growth

The whole pie is growing

- Do we have reliable sources of historic and projected industry growth rates?
- Do the company's projections reflect these industry expectations?
- What makes our 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?

Of note: An industry that is growing rapidly will eventually slow to a pace more similar to the growth of the overall economy.

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?

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

Projection Details

Sum & 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 depict 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.

Projection Details

Sum & 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 operational leverage of the business.

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

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

What if no projections were prepared?

- Valuation methodology always considers projections—either discrete or implied
- ***Income Approach***—DCF and single period methods make assumptions about the company's growth
  - Capitalization rate = Discount rate – ***Growth***
- ***Market Approach***—What is a market multiple?
  - Inverse of a capitalization rate (or 1 / (Discount – ***Growth***)

When no discrete projection exists, the financial advisor and trustee must be aware of the <u>implied projection</u> the valuation is based on.

Income Approach Foundation

SPC & DFC

Single-Period Capitalization ("SPC")

$$\text{Value} = \text{Cash Flow} \div \underbrace{\text{Capitalization Rate}}_{CR\ =\ r\ -\ g}$$

Discounted Future Benefits (DFC)

$$\text{Value} = \underbrace{\frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_n}{(1+r)^n}}_{\substack{\textit{Discrete Projection Employed} \\ \textit{Until Cash Flow is Stabilized}}} + \frac{SPC_{\text{Terminal}}}{(1+r)^n}$$

Income Approach Foundation

It's all about Growth!

Single-Period Capitalization ("SPC")

$$\text{Value} = \text{Cash Flow} \div \underbrace{\text{Capitalization Rate}}_{CR\ =\ r\ -\ g}$$

Discounted Future Benefits (DFC)

$$\text{Value} = \underbrace{\frac{\xrightarrow{g_1} CF_1}{(1+r)^1} + \frac{\xrightarrow{g_2} CF_2}{(1+r)^2} + \frac{\xrightarrow{g_3} CF_n}{(1+r)^n}} + \frac{\xrightarrow{g_T} SPC_{\text{Terminal}}}{(1+r)^n}$$

Discrete Projection Employed
Until Cash Flow is Stabilized

Income Approach Foundation

The SPC – it's not if, it's when

Single-Period Capitalization ("SPC")

$$\text{Value} = \text{Cash Flow} \div \underbrace{\text{Capitalization Rate}}_{CR\ =\ r\ -\ g}$$

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Discrete Projection Employed
Until Cash Flow is Stabilized

What if no projections were prepared?

Single-Period Capitalization

- Who thinks the growth rate in a SPC is not a projection (sheep in wolf's clothing)?
- Who thinks the perpetual growth rate in a SPC must reconcile to specific internal & external rate references (like inflation or GDP or an industry measure)?

Which is harder to believe (refer to next slide):

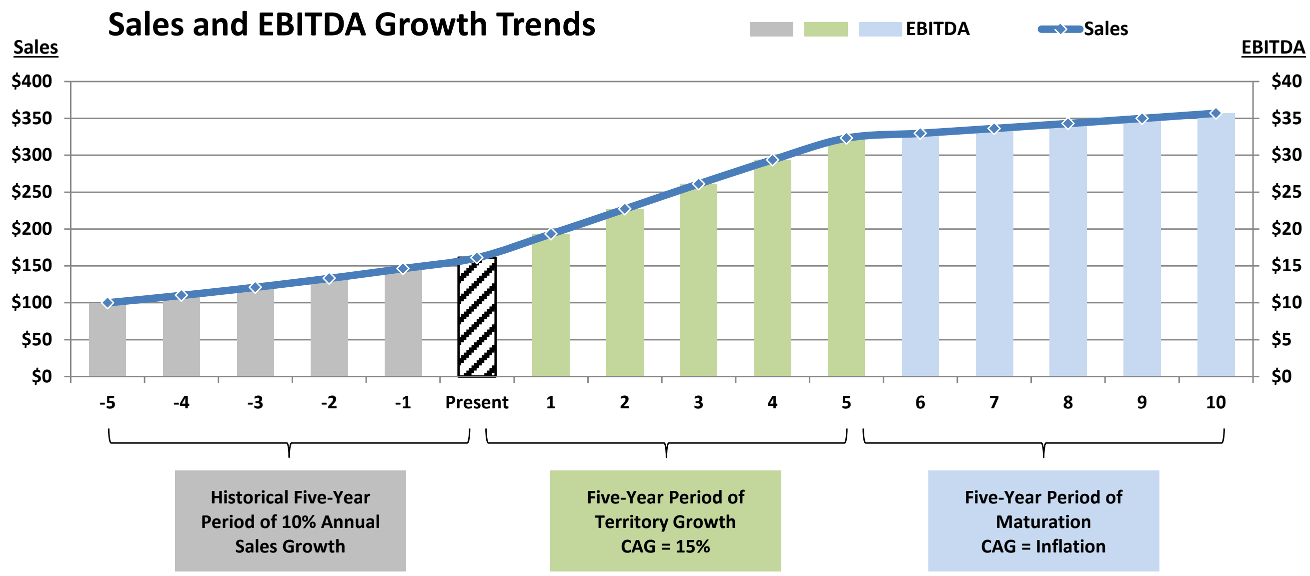
A SPC growth rate of 6% - 7%?

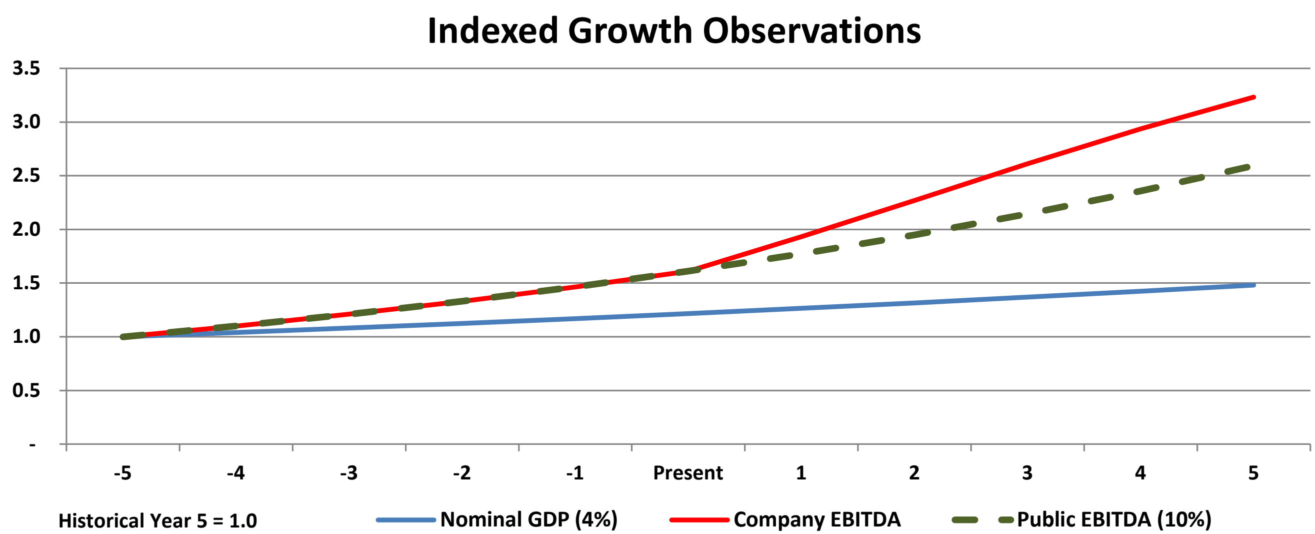
or

A Projection with 15% projected growth followed by inflationary growth thereafter?

Visualizing Growth

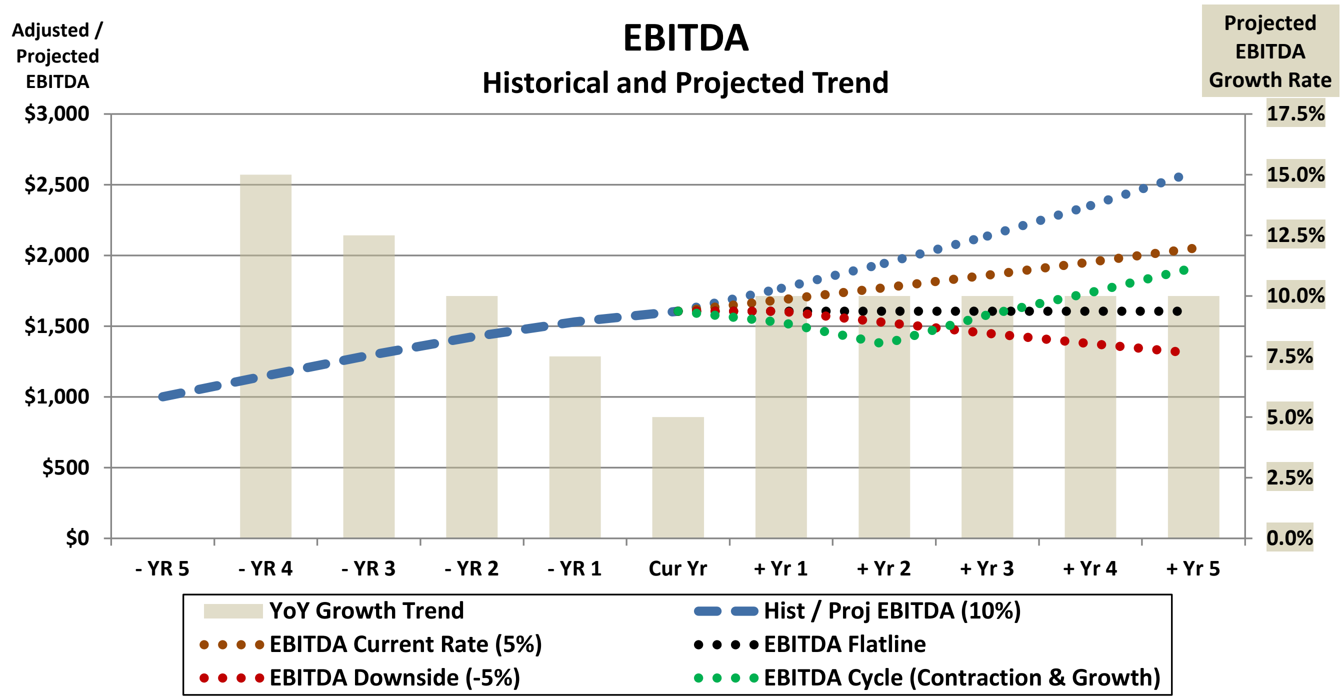
Do you buy the projection?





Visualizing Growth

Scenario testing: Example of decelerating growth and 10% mgmt. forward growth projection



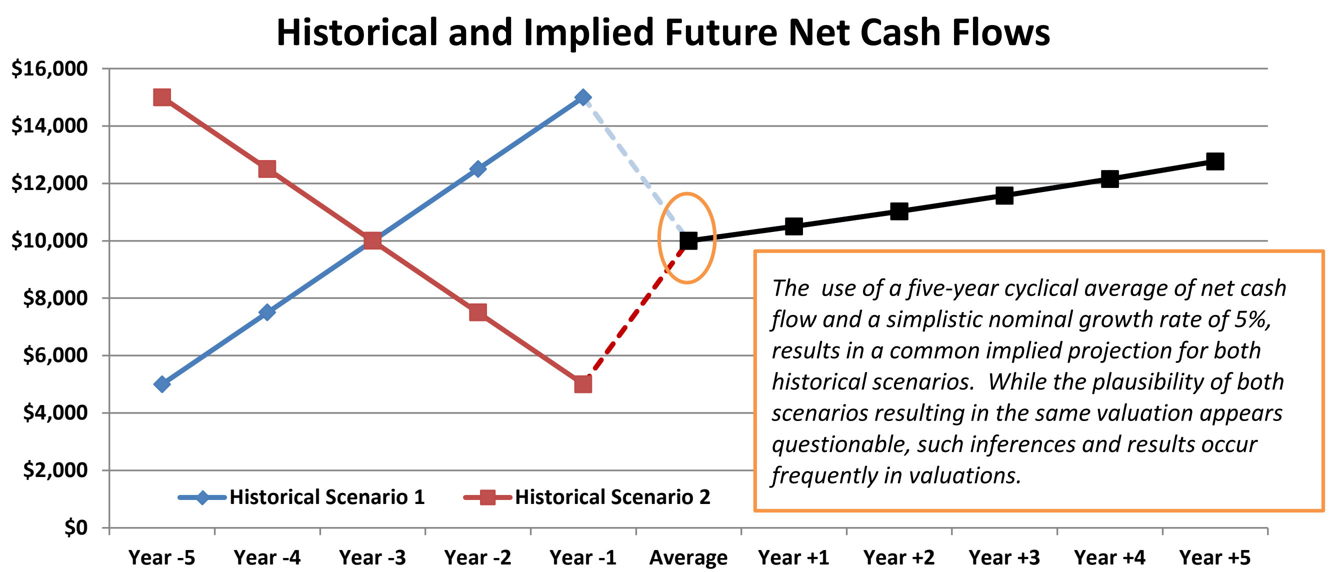
Visualizing Growth

Case study to assess growth alternatives

Ah - the five year average used in a SPC…

…but doesn't the timing of growth matter?

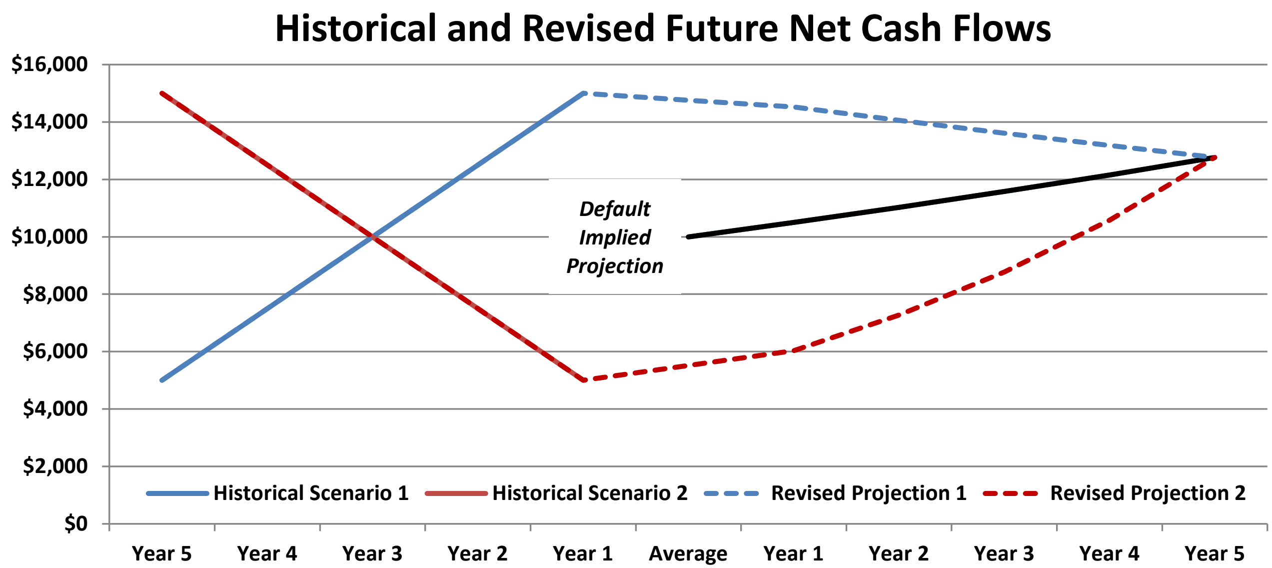
Example of two companies often valued the same but headed in different directions



Visualizing Growth

Alternative Growth Pathways

Would it be reasonable to assume regression to a future cash flow norm?



Visualizing Growth

Alternative Growth Pathways

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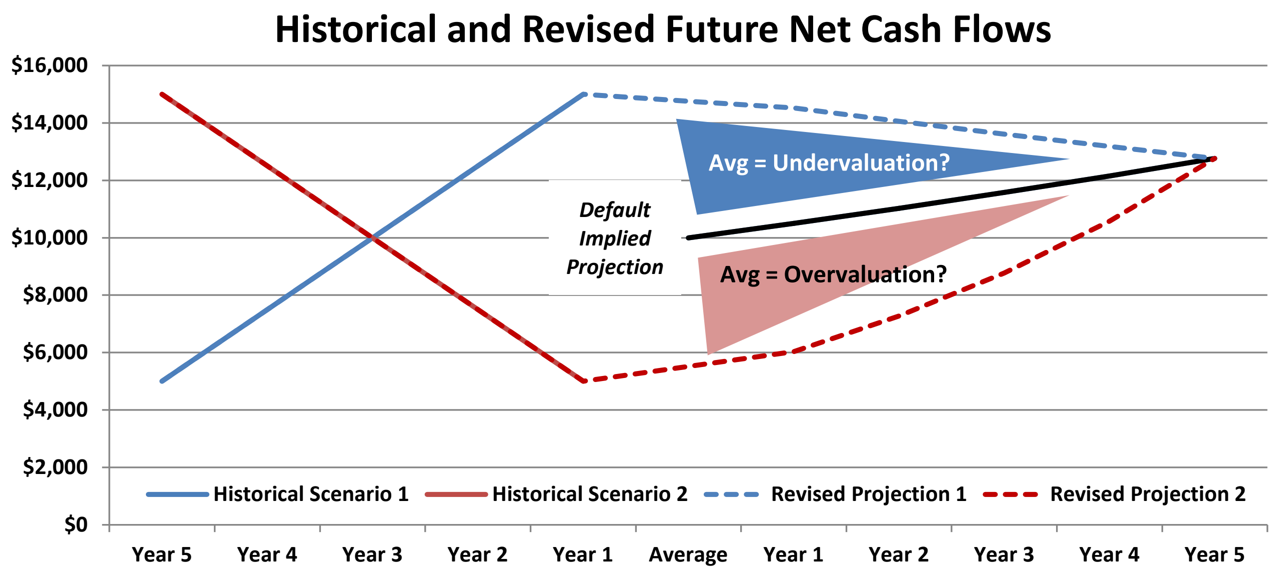
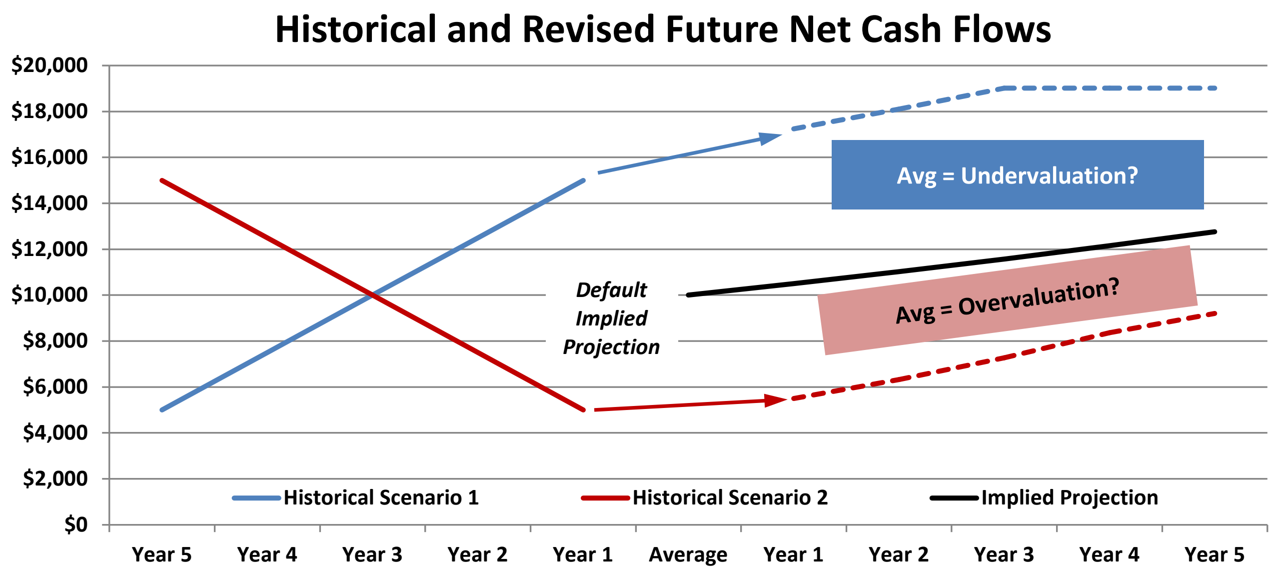


Visualizing Growth

Alternative Growth Pathways

Would it be more reasonable to assume growth rate regression to a future norm?



The Timing of Growth

Shortcut from multi-stage growth to single period growth; converting a two-stage DCF growth model into a SPC

Discount Rate = 13.0%

Long-Term Growth Rate; Terminal Growth

Short-Term Growth Rate of Net Cash Flow; DCF Discrete Growth Rates for Years 1 to 5

	2%	2.5%	3%	3.5%	4.0%	4.5%	5%	5.5%	6.0%	6.5%	7%
2%	2.0%	2.3%	2.7%	3.0%	3.4%	3.8%	4.2%	4.6%	5.0%	5.5%	5.9%
3%	2.3%	2.7%	3.0%	3.4%	3.7%	4.1%	4.5%	4.9%	5.3%	5.7%	6.2%
4%	2.6%	3.0%	3.3%	3.6%	4.0%	4.4%	4.7%	5.1%	5.5%	5.9%	6.4%
5%	3.0%	3.3%	3.6%	3.9%	4.3%	4.6%	5.0%	5.4%	5.8%	6.2%	6.6%
6%	3.3%	3.6%	3.9%	4.2%	4.5%	4.9%	5.2%	5.6%	6.0%	6.4%	6.8%
7%	3.5%	3.8%	4.2%	4.5%	4.8%	5.1%	5.5%	5.9%	6.2%	6.6%	7.0%
8%	3.8%	4.1%	4.4%	4.7%	5.1%	5.4%	5.7%	6.1%	6.4%	6.8%	7.2%
9%	4.1%	4.4%	4.7%	5.0%	5.3%	5.6%	5.9%	6.3%	6.6%	7.0%	7.4%
10%	4.4%	4.6%	4.9%	5.2%	5.5%	5.8%	6.2%	6.5%	6.8%	7.2%	7.6%
11%	4.6%	4.9%	5.2%	5.5%	5.7%	6.1%	6.4%	6.7%	7.0%	7.4%	7.7%
12%	4.8%	5.1%	5.4%	5.7%	6.0%	6.3%	6.6%	6.9%	7.2%	7.5%	7.9%
13%	5.1%	5.3%	5.6%	5.9%	6.2%	6.5%	6.8%	7.1%	7.4%	7.7%	8.1%
14%	5.3%	5.6%	5.8%	6.1%	6.4%	6.7%	7.0%	7.3%	7.6%	7.9%	8.2%
15%	5.5%	5.8%	6.0%	6.3%	6.6%	6.8%	7.1%	7.4%	7.7%	8.0%	8.4%
16%	5.7%	6.0%	6.2%	6.5%	6.8%	7.0%	7.3%	7.6%	7.9%	8.2%	8.5%

Q&A and Due Diligence

- 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 function purpose of the projections?
  - Sales goals
  - Budgeting
  - Annual line of credit negotiations
  - Other third party reliance?

Q&A and Due Diligence

- How experienced in 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”)

Q&A and Due Diligence

- 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?

Q&A and Due Diligence

- 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?

Q&A and Due Diligence

- How comprehensive are the projections and the supporting documentation?
- Is it within the appraiser’s judgment to hedge a projection?

Questions?

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