The ESOP Association

Forecasting Profit and Loss for ESOP Valuations

Midwest Regional Conference| Minneapolis, MN

September 12, 2019

ADMIN

- Please fill out a session evaluation on the mobile app
- Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs
- Remember to get your CPE sheet stamped before and after each session for CPE credit

Forecasting Profit and Loss for ESOP Valuations

Midwest Regional Conference| Minneapolis, MN

Hillary Hughes
Prairie Capital Advisors
hhughes@prairiecap.com
319.366.3045

Teresa Daggett
TI-Trust
Teresa.Daggett@ti-trust.com
217.228.6828

Dan Markowitz
Boulay PLLP
dmarkowitz@boulaygroup.com
952.841.3027

Today's Agenda

- Introduction/Overview
- Related court cases
- Forecasting profits and losses
- Analyzing projections

Setting the Table

- Projections are the #1 issue in ESOP litigation
  - Majority of ESOP litigation involves valuation issues
  - Validity of projections assumptions utilized
  - Process/Settlement agreements focus heavily on projections
- Valuation of ESOP Companies
  - The value of a company is based on the future (not the past)
  - All valuation methods rely on assumptions of the future
  - Explicitly or implicitly relies on financial projections

DOL Perspective on Projections

- Tim Hauser of the DOL:
- "I see the use of aggressive and unrealistic projections as a chronic problem with ESOPs."
- "People need to think hard and perform some level of scrutiny related to the projections. And in the cases we bring, we just don't see that."
- "We just see management projections getting plugged right in to the ESOP appraisal without a critical review. Everybody moves on and does their math based on these management projections without 'kicking the tires.'"

DOL Perspective on Projections

Questions that should be asked about the projections:

- How do the projections compare to the performance and projections of the company's peers?
- How do the projections compare to the historical performance of the company?
- How plausible is it that the company could really go forward with these projections?
- How volatile or sensitive are the projections to various assumptions?
- What happens if there is a recession?

Source: *Tim Hauser of the DOL*

Projection Issues in Recent ESOP Litigation

Projection Issue	Total (16 Cases)	Constellis	SJP	Big G Express	Graphite Sales	Tobacco Rag	Sonnax	Mona Vie	Sentry	Commodity Control	Gruber	AIT Labs	Maran	Rembar	Sierra Aluminum	Parrot Cellular	Bruister
Revenue Growth Rate	12	X	X	X	X		X	X			X	X	X		X	X	X
Margins	8					X	X				X	X	X		X	X	X
Inconsistent with Historical	9		X		X		X	X		X	X		X		X		X
Inconsistent with Industry	8		X	X		X				X		X	X		X		X
Inconsistent with Economy	3		X	X									X				
Prior Projections	2	X										X					
Compensation	3					X								X		X	
Capital Expenditures	2											X			X		
Cyclical	4		X						X				X		X		
Customer Concentration	5	X	X			X							X				X
Long-term Growth Rate	2						X			X							
Lack of Projections	1								X								

Projection Issues in ESOP Litigation

- Using financial performance estimates that are inconsistent with the actual financial performance of the company
- Aggressive and unsupportable growth projections
- Competitive position not supportable
- Failure to account for declining performance within company and broader economy
- Failure to consider customer concentration or cyclical trends
- Unduly optimistic operating margin projections, out of line with projections within the most analogous industry

Settlement Agreements with DOL

- Who is responsible for projections
- Any conflicts of interest
- Document the reasonableness of projections
- Comparison to 5 year historical averages/medians for company and comparable public companies:
  - Return on assets (ROA) and Return on Equity (ROE)
  - EBIT and EBITDA margins
  - Cap ex as a % of sales
  - Revenue growth rate
  - Ratio of free cash flows to sales
- Document any projection adjustments and why
- Ability to service the debt

Conflicts of Interest

- Preparation of Projections
  - Financial advisor to seller prepares the projections
  - Projections prepared by the valuation firm (not ideal)
- Management Motivation
  - Incentive to provide overly optimistic projections
- Relying on Projections
  - Can still rely on projections where an apparent conflict of interest may exist
  - Conflict should be examined and documented
- Documentation of Conflict of Interest
  - Document in writing
  - Trustee and Valuation advisor dealt with conflict of interest

Roles & Responsibilities

- **Management:**
  - Prepare & take responsibility for projections
  - Develop support for key assumptions
- **Company/Seller Advisors:**
  - Review for reasonableness before "published"
  - Help management substantiate key assumptions
- **ESOP Valuator:**
  - Review, understand, question & scrutinize
  - Compare with past performance & industry trends
  - Assess level of conservatism & aggressiveness

Roles & Responsibilities

- **ESOP Trustee:**
  - Review, question, understand & scrutinize
  - Understand valuator's analysis of projections
  - Ultimately approve the value conclusion based on projections and valuator assessment of them
- **CPA Firm:**
  - Coaching on preparing financial projections for the initial ESOP transaction

Why is the Forecast Important?

- In short…. it effects the VALUE!
- Key component of income approach, market approach and transaction approach
- Underlying assumptions drive relative pricing

Is It Better Not to Forecast?

- Can we avoid scrutiny by not forecasting?
  - In short… NO!

- The appraiser will still need to make assumptions on future performance
  - Implicitly – perpetuation of historic trends
  - Explicitly – use of growth and margin estimates

- All investors are interested in future performance

Currently We Have No Forecast…

- How do you measure internal performance?
- Are there any monthly, regional or annual sales goals?
- How do you access management team performance?
- Is any part of your organization commission based?
- When talking with customers, how far out are you discussing business? Next week, quarter or year?
- Do you receive any blanket P.O.s or long-term contracts?
- Do you have any long term supply agreements? What's the minimum purchase amount?

Where to Start Forecasting

- Top Down
  - Revenue driven
  - Based on specific performance targets
  - Visibility from the ‘c’ suite

- Bottom Up
  - Sales based on “in-field” representatives
  - Line item cost forecast
  - Assesses needs of each department or location

Where to Start Forecasting

- Get Input
  - Not just a CFO or Controller function!
  - What does the sales team think?
  - Is purchasing and production on board?
  - Do we have the right team structure to execute?

- How are we doing?
  - Revisit results
  - Analyze where insight is strong and where it is weak
  - Share results and ask for input

Thinking Strategically

- Competitive Advantage
  - What do you need to do to maintain?
  - What do you need to do to grow?
    - Additional employees or more capital expenditures
  - How will this impact your ESOP obligations?

- Do your competitors forecast?
  - Where are they investing?
  - Are they opening new locations?
  - What does this mean for you?

Benefits of Preparing Projections

- Not just a valuation exercise
- Strategic/Corporate planning
  - 1, 3, 5 year planning
  - Understand what is happening in the business
- Cash flow Needs
  - Future cash flowing planning
  - Acquisitions, Capital Assets, Organic Growth, etc.

Analysis of Projections

- Growth Rate Assumptions:
  - Historical
  - Industry projections
  - Comp projections
  - Capacity to grow
- Customer Concentrations:
  - Terms of Contract
    - Termination clause
  - Can the customer be replaced
  - Financial stability of customer
    - Review of their financial statements

Analysis of Projections

- Industry Trends:
  - Is there a shift in the industry?
  - Long-term industry forecast
    - Trade publication, economic indicators, etc.
  - Status of industry business cycle
  - Industry competition
    - Barriers to enter
  - Political effect or national election
- Business Segments:
  - Discontinue of segment
  - Profitability by segment

Analysis of Projections

- Business Trends
  - One-time vs. recurring revenue streams
  - Payment terms of revenue stream
  - Fixed vs. variable costs
- Talent
  - Current capacity
  - Ability to hire additional people
    - How long will take
  - Impact of retirements

Analysis of Projections

- Suppliers
  - Key Supplier agreement
  - Can the Supplier be replaced?
  - Termination provisions
  - Can supplier handle growth
    - What is the supplier’s capticity?
  - Financial stability of supplier
- Risk Adjusting Financial Projections:
  - Who prepared them?
  - History with projections
  - Any warning signs about the projections?

Analysis of Projections

- Gross profit
  - In line with historical trends
- Capital expenditures
  - Support growth of the projections
  - Capacity availability
- Corporate tax rate
  - Valuation as if a C-Corp
  - Tax rates matter even 100% S-Corp
- ESOP Compensation
  - Normalized retirement benefit level

Projected Compensation

- **Executive compensation/employment agreements**
  - Need to ensure that these are reflected properly in projections
- **Deferred compensation agreements**
  - If not in the projections, need to be reflected somewhere in the valuation
- **Stock appreciation rights/stock options**
  - Current debate about whether SARs/stock options issued as part of transaction should be included/reflected in valuation. DOL says yes.
- **ESOP contribution expense**
  - Arises post-transaction for annual update valuation. Question is whether to normalize and if so at what level

Projected Compensation Issues in Litigation

- Parrot Cellular – projections used in valuation failed to include a $12MM deferred compensation agreement to seller
- Laser Skin & Surgery – projections used “market level” of compensation for selling shareholder, which was significantly lower than employment agreement entered into with seller at time of transaction
- Sentry Equipment – expert dispute related to projected compensation. DOL expert failed to normalize lower executive compensation expected post transaction.

Annual Update vs. Initial Transaction

- **Initial transaction**
  - Guidance in settlement agreements on projections relates to purchase transactions by the ESOP
  - Higher risk for conflict of interest issues if sell side advisor prepares projections
  - Higher level of scrutiny and litigation risk
  - Can choose not to do the deal if issues with projections cannot be resolved
  - Typically no history of company's ability to meet projection
- **Annual update**
  - No guidance from DOL
  - Typically have a history of company's ability to meet projections
  - Treatment of projected ESOP contribution expense
  - Lower level of scrutiny and litigation risk, but can cause problems if second stage transaction or if company is later sold

Transaction Risk - Projections

- Trustee
  - Working capital adjustment
    - Target working capital threshold
  - Earnout
  - Clawback
  - Seller financing
- Financial Advisor
  - Identify aggressive projections
  - Sensitivity analysis
  - Adjustment of discount rate
- CPA Firm
  - Reliable reviewed or audit financial statements

Forecast in Light of DOL Scrutiny

- Documentation is key!
- Hindsight is 20/20 – what are you doing to capture your business judgment today?
- DOL Audits are part of being an ESOP
- Remember, you still know the most about your business.
  - What you communicate and the data you share is key to improving and enhancing the valuation process

Question and Answers