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Let's get there

Project Runway:

Making the Most of Time until Departure from a Privately-Held Company

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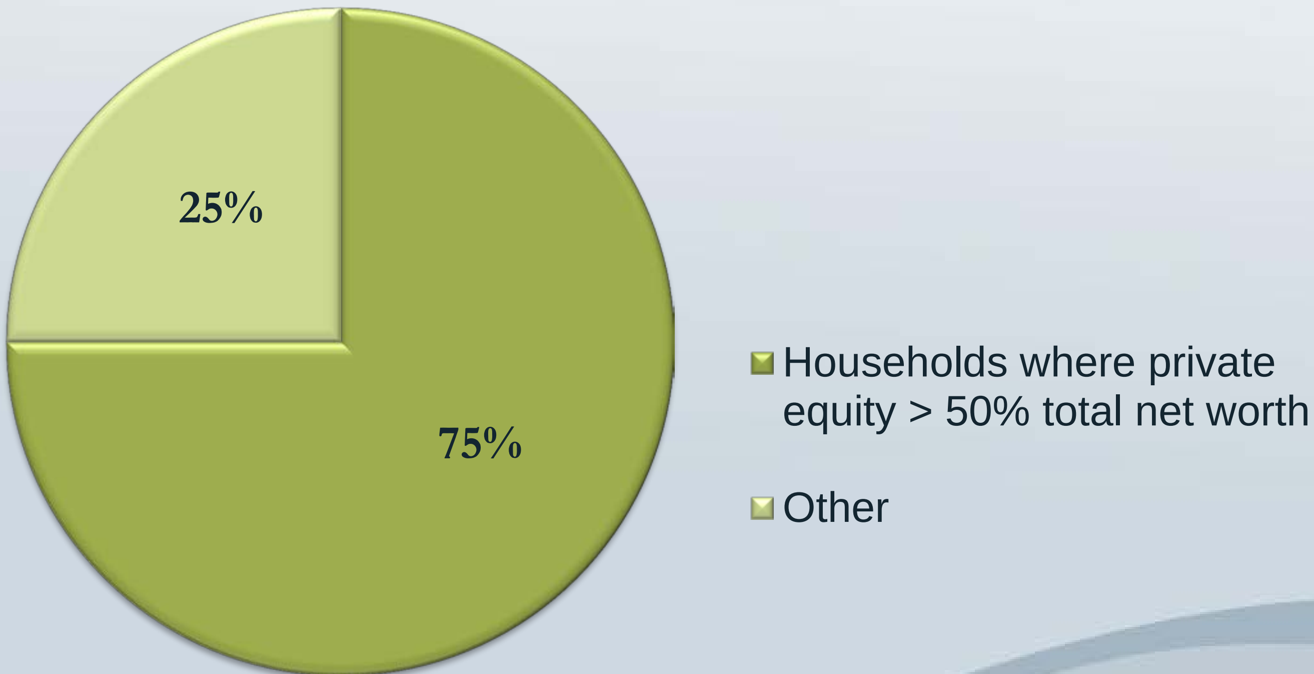
Private Company Wealth

Private Equity Ownership



Source: Returns to Entrepreneurial Investment research paper, Tobias J. Moskowitz & Annette Vissing-Jorgensen

Private Company Wealth

- "… households with entrepreneurial equity invest on average more than 70 percent of their private holdings in a single private company in which they have an active management interest."
- "Private equity returns are on average no higher than the market return on all publicly traded equity."

Source: Returns to Entrepreneurial Investment research paper, Tobias J. Moskowitz & Annette Vissing-Jorgensen

Private Company Wealth

- Summary of research by Moskowitz & Vissing-Jorgensen:
  - "…survival rates of private firms are only around 34% over the first 10 year's of the firms life."
  - "…the distribution of equity returns across entrepreneurs is wide."
  - "…average entrepreneur holds most of his investment in the same private firm in which he works, making his equity return highly correlated with his human capital return."
  - "...difficult to precisely estimate overall risk of private equity…. the index of private equity is likely as volatile as the public equity index and that aggregate private equity returns are highly correlated with the public equity market."
  - Concluded that private equity returns are low.

Source: Returns to Entrepreneurial Investment research paper, Tobias J. Moskowitz & Annette Vissing-Jorgensen

Wealth in closely-held businesses

- Q: How do you consider that private company wealth in your planning?
- Planning opportunities
  - Increase value in their private company (and thus their wealth)
  - Mitigate risk (diversify)
  - Implement Succession planning
  - Deal with illiquidity

Private Company Returns

How do we value/measure performance of various investments?

$$\text{Return} = \frac{\text{(Dividends + realized capital gains + unrealized appreciation)}}{\text{Beginning Value}}$$

Private Company Returns

How do we value/measure performance of various investments?

Investment	Performance measurement
Marketable securities and retirement plans	Returns = dividends + cap gains + appreciation
Real estate	Returns = cash flow & appreciation
Closely-held businesses	Returns = distributions & ___?___

An interest in a closely-held business is often the biggest portion of a client's net worth, yet we don't always know what it is worth or what kind of return it generates.

Private Company Returns

› Utilization of private company returns
  – Tracking trend in returns for subject company
  – Impact of certain decisions
  – ROI on specific reinvestments
  – Alternative funding mechanisms
  – Leverage analysis
  – Diversification, creating (partial) liquidity
  – Return maximization w/ in portfolio/optimum deployment
  – Peer/industry comparison

Management fee based on $AUM

Assumed Pre-Tax Income	Assumed Valuation Multiple	Estimated Value of Business Equity	Management Fee as a % of Value	One Percent Management Fee Budget
$ 1,000,000	4.0	$ 4,000,000	1.00%	$ 40,000
$ 1,500,000	4.5	$ 6,750,000	1.00%	$ 67,500
$ 2,000,000	5.0	$ 10,000,000	1.00%	$ 100,000
$ 2,500,000	5.5	$ 13,750,000	1.00%	$ 137,500
$ 3,000,000	6.0	$ 18,000,000	0.50%	$ 90,000
$ 3,500,000	6.5	$ 22,750,000	0.50%	$ 113,750
$ 4,000,000	7.0	$ 28,000,000	0.30%	$ 84,000
$ 4,500,000	7.5	$ 33,750,000	0.25%	$ 84,375
$ 5,000,000	8.0	$ 40,000,000	0.25%	$ 100,000

Source: Unlocking Private Company Wealth. Z. Christopher Mercer

Management fee based on $AUM

Possible uses for management fee budget:

- Wealth Manager Compensation
- Annual Appraisals and Monitoring of Performance
- Buy-Sell Agreement Pricing
- Life Insurance Funding
- Estate Planning

Source: Unlocking Private Company Wealth, Z. Christopher Mercer

Management fee based on $AUM

Possible uses for management fee budget:

- Ownership Transition Planning
- Financial Planning
- Annual Legal Review
- Outside Board Members
- Corporate Finance for Private Businesses

Source: Unlocking Private Company Wealth, Z. Christopher Mercer

Case Study #1 – Annual calculation

1978
Founded

1998
Shareholder Agreement outlines methodologies to be utilized to annual calculation

2014
Client met with their attorney team and agreed on revised Shareholder Agreement.

Case Study #1 – Annual calculation

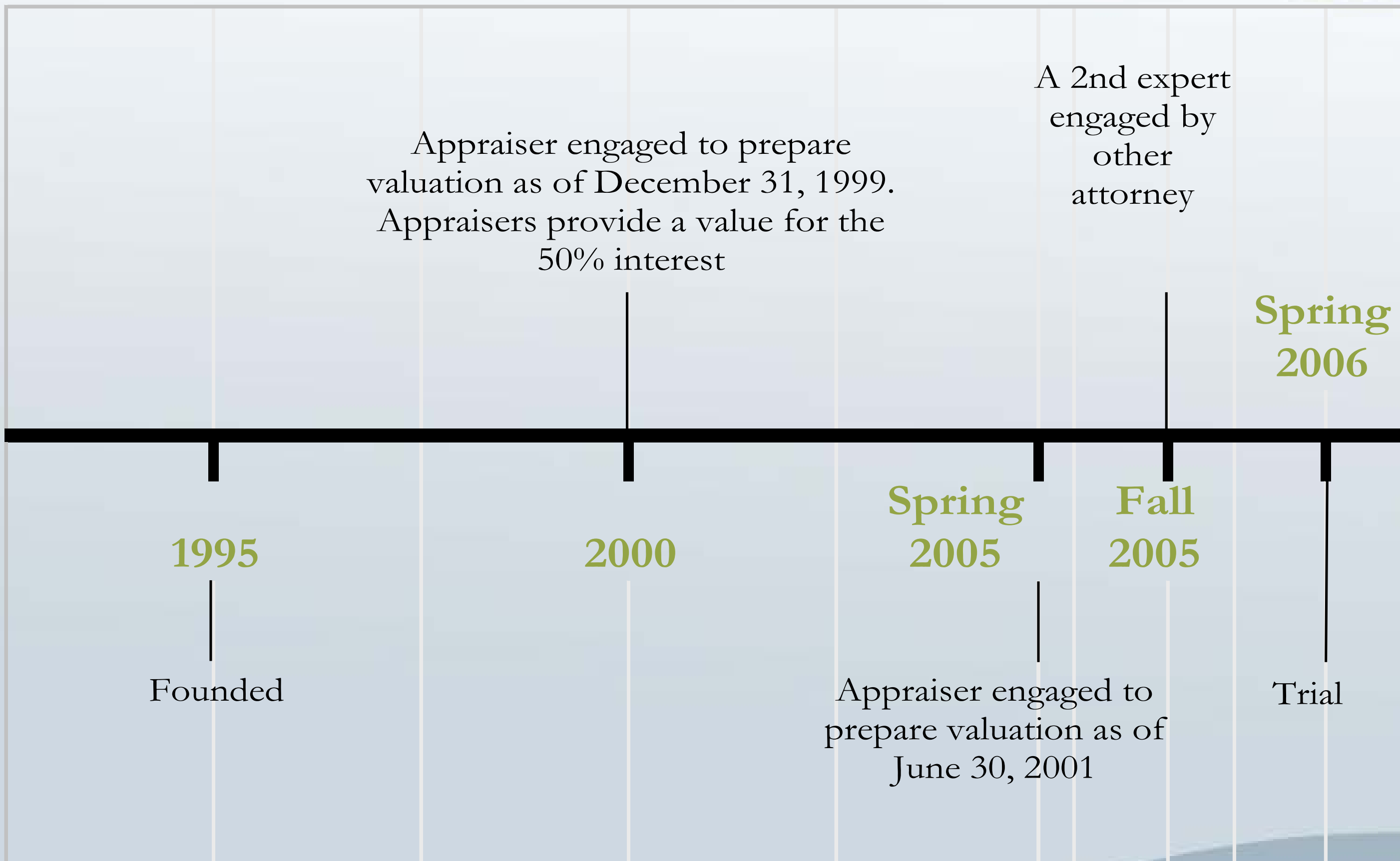
- Appraiser's identification of issues provided attorney with opportunity to work with ownership team to:
  - get to agreement on the succession and valuation issues,
  - prevent business disruption,
  - prevent financial and emotional stress, and
  - preserve long-term relationships.
- For this company, the cost for an annual calculation is less than 10 basis points.

Utilizing valuation as a tool

Buy-Sell

- Prevent future cash outlay for litigation
- Risk mitigation
- Clarity for:
  - Existing owners
  - Next generation
  - Identified internal talent
  - Key members of management

Case Study #2 – Buy-Sell Risk Mitigation



Case Study #2 – Buy-Sell Risk Mitigation

- Result:
  - Company in turmoil for 6 years, preventing them from devoting 100% of their efforts to growing and improving the business
  - Litigation was costly, both emotionally and financially (legal fees + valuation fees > original proposed buyout).
- Takeaways:
  - "Begin with the end in mind." - Stephen R. Covey Discussions about compensation and exit planning should be discussed in the beginning.
  - Seek out valuations early (and regularly) to set price and work through conceptual issues in the valuation, especially inclusion or exclusion of discounts.

Utilizing valuation as a tool

Operational improvements and advancing transition readiness

- Impacts on value
- Concentrations
- Key Person conversion – Value transfer
- Curb appeal/staging

Case Study #3 – Transition Readiness

Summer 2012
CPA Firm engaged to assist with calculation and fee quotes for audit

Calculation performed, but audit not pursued

End of 2012
Deal closed

Within a few months after sale, buyer proposed purchase price adjustment of over 40% of total purchase price

Next 2 years
Attorneys continue to communicate, along with ongoing negotiation

Beginning 3rd year of dispute resolution
Sellers have not received the scheduled payments on notes receivable or earn out payments

Case Study #3 – Transition Readiness

- Takeaways:
  - It is important to get a business and the owners ready for a sale.
  - Importance of a clear, consistent history of quality financial reporting cannot be understated.
  - Transition planning for C-level management, including talent recruitment, is crucial.
  - Consider all possibilities for liquidity events for key members of management.

Case Study #3 – Transition Readiness

› Takeaways:

- In family businesses, assistance from consultants/coaches with experience in transitions can be extremely valuable.
- Family governance issues must be addressed.
- Fee sensitivity prevented dynamic, collaborative team approach with advisors. Hesitancy to invest in "getting ducks in a row" has proven to be extremely expensive.
- Value loss from a "fixer-upper" can be quite painful. Bringing a business to market should be done carefully, **utilizing as much time as possible to prepare a business to be ready and packaged for sale.**

Utilizing valuation as a tool

Life insurance planning

- Ensuring sufficient coverage
- Providing clarity on effect on value
- See case study #4

Case Study #4 – Life Ins. Planning

1978
Founded

Owners addressed some planning issues with the Company's CPA and attorney

Spring 2007
50% shareholder passes away

June 2007
Company engaged CPA firm to appraise the 50% interest owned by the decedent. Result: $5.4M

The representative for the decedent's estate disputed the value and retained another appraiser to value the 50% interest. Result: $7.9M

2010
Case went to court. Company worth only $3M. 50% buyout ordered at $3.95M

Case Study #4 – Life Ins. Planning

- Takeaway:
  - Lack of documentation and clarity in the governing documents resulted in a costly & lengthy litigation with the departed shareholder's estate and a share redemption that was greater than the entire company value.
  - Get clarity among owners about life insurance and effect on value.
  - Obtain valuations regularly to ensure sufficient coverage.

Utilizing valuation as a tool

- Alternative capital structures
  - Evaluation of liquidity goals
  - Analysis of liquidity options
    - Dividends
    - ESOP
    - Minority interest private equity
    - Leveraged share repurchase

Case Study #5 – Share Repurchase

Key Transaction Assumptions	Values	Comments
Number of Shares to be Purchased	25,000	Founder's outstanding shares (25%)
% of Cash Considered Excess	95.00%	Use most cash on balance sheet
EBITDA Multiple for Pricing Transaction	6.5	Implied multiple from recent valuation
Dollars of Current Annual Dividends	$ 2,500,000	Current dividend policy
Given Number of Shares for Example	10,000	10% block
Interest Rate on Pro Forma Cash	1.00%	Assumption per banker
Interest Rate on Pro Forma Debt	6.00%	Assumption per banker
Effective Tax Rate	35.00%	Federal only
EBITDA Multiple for Pro Forma #1 Valuation	6.5	No change in EBITDA Multiple
Shares Outstanding	100,000	

Source: Adapted from Unlocking Private Company Wealth. Z. Christopher Mercer

Case Study #5 – Share Repurchase

Contemplated Transaction				
No. of Shares to be purchased			25,000	Founder's outstanding shares (25%)
Price per Share		$	1,372.50	
		$	34,312,500	
Sources of Financing				
Internal Cash	95.00%	$	19,000,000	Cash to be used in repurchase
Long-term borrowing for transaction	Remainder	$	15,312,500	
		$	34,312,500	
Existing Debt Prior to Transaction		$	15,000,000	
Long-Term Borrowing for Transaction		$	15,312,500	
Pro Forma Debt		$	30,312,500	

Case Study #5 – Share Repurchase

BALANCE SHEET	Actual	Adjustments	Proforma
ASSETS			
Cash	$ 20,000,000	$ (19,000,000)	$ 1,000,000
A/R	30,000,000		30,000,000
Inventory	60,000,000		60,000,000
Total Current Assets	110,000,000	(19,000,000)	91,000,000
PP&E	30,000,000		30,000,000
Total Assets	$ 140,000,000	$ (19,000,000)	$ 121,000,000
LIABILITIES & STOCKHOLDERS' EQUITY			
Current Liabilties	$ 30,000,000		$ 30,000,000
Long-term interest-bearing debt	15,000,000	15,312,500	30,312,500
Other Long-debt liabilities	5,000,000		14,997,500
Total Long-term liabilities	20,000,000	15,312,500	45,310,000
Total Liabilities	45,000,000	15,312,500	60,312,500
Stockholders' Equity	95,000,000	(34,312,500)	60,687,500
Total Liabilities & Stockholders' Equity	$ 140,000,000	$ (19,000,000)	$ 121,000,000

Case Study #5 – Share Repurchase

	Actual	Adjustments	Pro Forma EBITDA Multiple Unchanged	% Change
Net Sales	$ 280,000,000		$ 280,000,000	
Cost of Sales	220,000,000		220,000,000	
Gross Profit	60,000,000		60,000,000	
Operating Expenses	45,000,000		45,000,000	
Operating Income/(Loss)	15,000,000		15,000,000	
Other Income/(Expense)				
Interest Income / Proforma	300,000	(285,000)	15,000	
Interest (Expense)	(1,100,000)	(718,750)	(1,818,750)	
Other, Net	-		-	
Total Other Income/(Expense)	(800,000)		(1,803,750)	125.5%
Pre-Tax Income/(Loss)	14,200,000		13,196,250	-7.1%
Income Tax (Expense)/Benefit	(4,970,000)		(4,618,688)	-7.1%
NET INCOME/(LOSS)	$ 9,230,000		$ 8,577,563	-7.1%
Shares Outstanding	100,000	(25,000)	75,000	-25.0%

Case Study #5 – Share Repurchase

	Pre-Transaction		Proforma #1	% Change
	Assumption #3		Assumption #9	
EBITDA	$ 20,500,000		$ 20,500,000	
Appropriate Multiple	6.5		6.5	0.0%
Market Value of Invested Capital (MVIC)	133,250,000		133,250,000	0.0%
Less: Interest-Bearing Debt	(15,000,000)	(15,312,500)	(30,312,500)	
Excess Cash	19,000,000	(19,000,000)	-	
Market Value of Equity	137,250,000	(34,312,500)	102,937,500	-25.0%
Returns				
Return on Equity	9.7%		14.1%	45.5%
EBITDA Margin	7.3%		7.3%	0.0%
Net Margin	3.3%		3.1%	-7.1%
Leverage				
EBITDA/Interest Expense	18.6		11.3	
Debt/EBITDA	0.73		1.48	
Interest-Bearing Debt/Equity	15.8%		49.9%	
Current Ratio	3.7		3.0	

Case Study #5 – Share Repurchase

Shareholder Information	Actual		Pro-Forma #1	% Change
Shares Outstanding	100,000	(25,000)	75,000	-25.0%
Price Per Share	$ 1,372.50		$ 1,372.50	0.0%
Earnings Per Share	$ 92.30		$ 114.37	23.9%
Dividends Per Share	$ 25.00		$ 33.33	33.3%
Book Value Per Share	$ 950.00		$ 809.17	-14.8%
Price/Earnings Multiple	14.9		12.0	
Price/Book Value	144.47%		169.62%	
Dividend Yield	1.821%		2.429%	
Dividend Payout Ratio	27.1%		29.1%	7.6%
Given Number of Shares for Example	10,000		10,000	
Value of a Given Number of Shares	$ 13,725,000		$ 13,725,000	0.0%
Percentage of Company for Selected Block	10.0%		13.3%	33.3%
Dividend Cash Flow for Those Same Shares	$ 250,000		$ 333,333	33.3%

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Case Study #5 – Share Repurchase

› Takeaway:

- Founder receives over $34 million to diversify his holdings and invest elsewhere.
- Remaining shareholders receive 33% higher dividends and now hold 33% more shares for future sale.
- Company is leveraged at a reasonable level.

Recap

› Put fees to manage private company wealth in context of fee based on $AUM

› Work with the other professionals and use the runway to:

- maximize wealth
- diversify risk
- implement succession planning
- address liquidity for clients

Recap

- Think of valuation as a tool for:
  - Evaluating private company returns
  - Buy-sell considerations
  - Operational improvements & advancing transition readiness
  - Life insurance planning
  - Considering alternative capital structures

Questions?

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