

Valuations for established ESOP's

Paul Maarschalk BA; CPA, CA; CBV

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Contents

A: Quick recap – your ESOP journey to date	3
B: Valuation methods compared	4
Cost or adjusted net asset method	5
Capitalized earnings method	6
Market method	7
Formula method	8
Table 1: Valuation methods compared	9
My preferred usual process (simplified)	10
C: Common misunderstandings	11
Misunderstanding 1: That FMV is a multiple of historical EBITDA	12
Misunderstanding 2: That a valuation multiple is permanent	13
D: Private capital markets – 2017 Pepperdine report	14
Table 2: Suppliers of finance required rates of return	15
Table 3: Business owners' estimate of cost of equity	16

Presenter:

Paul Maarschalk CPA, CA; CBV

Maarschalk Valuations Inc. www.mvi.ca paul@mvi.ca

(778) 484-5572 or 1-877-730-3413 (TF)

A: Quick recap – your ESOP journey to date

1. Planning, planning, planning
2. Management / employees came to terms
3. Initial transfer / issue of shares at agreed value (usually as advised by a 3rd party valuator)
4. Company grows, employees participate
5. Share exchanges, new issues at value determined in terms of shareholders' agreement / ESOP agreement (annual valuation / formula / fixed)

B: Valuation methods compared

Cost or adjusted net asset method

1. Assumes there is no goodwill
2. Finds FMV of company by adjusting values of assets from book value to FMV at valuation date
3. Deducts liabilities from FMV of assets to get value of company
4. Comparatively easy, little judgment required
5. Suitable for holdco's or underperforming, capital intensive co's

Capitalized earnings method

1. Forward looking
2. Based on pro forma earnings or cash flows
3. Needs a capitalization rate (i.e. required yield on investment, determined through risk analysis)
4. Needs balance sheet analysis & identification of redundant assets & tax shields
5. Significant judgment involved
6. Suitable for mature, profitable co's

Market method

1. Usually based on historical results
2. Based on metrics for reported sales of comparable companies
3. Limited by suitability of information available
4. Requires judgment if properly done (getting comparability right)
5. Usually ignores redundant assets & tax shields
6. Suitable for “cookie-cutter” businesses or as a reasonableness check on other methods

Formula method

1. Usually based on historical results
2. Provides some certainty looking forward but
3. Certainty may not be a good substitute for accuracy
4. Based on judgment in year zero
5. Limited usefulness if the company's risk profile changes
6. Usually ignores redundant assets & tax shields
7. Suitable for stable, predictable co's in stable economic environments

Table 1: Valuation methods compared

	Viewpoint	Judgment	Accuracy	Complexity
Adjusted asset	Current	Limited	High	Low - NB no goodwill
Capitalized earnings	Forward looking	High	High	High
Market	Historical	Modest	Depends on comparatives	Low
Formula	Historical	High in year zero, limited thereafter	Assumes no change to risk profile	Low
Professional valuation fees are largely driven by the level of judgment and complexity				

My preferred usual process (simplified)

1. Develop pro forma cash flow statement, being results considered achievable in the current environment
2. Analyze company risks and determine weighted average cost of capital (WACC) *
3. Capitalize pro forma cash flows using WACC
4. Analyze balance sheet & identify redundant assets & tax shields
5. Estimate tangible asset backing[^] & calculate goodwill
6. Conclude enterprise FMV - higher of capitalized cashflow or tangible asset backing
7. Test enterprise FMV for reasonableness using, in part, market comparables
8. Add redundant assets
9. Deduct term loans, preferred shares
10. Finalize FMV of common shares

This process includes all major valuation methods (except formula).

*WACC = weighted average of the cost of equity and the cost of debt

[^] tangible asset backing = FMV of net assets used and needed to generate enterprise level cash flows (i.e. excludes redundant assets)

C: Common misunderstandings (in the context of ESOP's)

Misunderstanding 1: That FMV is a multiple of historical EBITDA

1. Historical EBITDA is often not the best base for a valuation – pro forma (i.e. forward looking) free cash flow (EBITDA less tax on EBITDA less sustaining capital spending) is usually preferable
2. Consideration must be given to the level of assets in the business. Many companies have more than necessary - excess (i.e. redundant) assets provide extra value
3. Consideration must be given to tax shields
4. Transaction advisers use recast EBITDA (but they do not aim for FMV)

Misunderstanding 2: That a valuation multiple is permanent

1. Value is a function of opportunity and risk
2. While opportunity may be easy to measure by way of earnings or cash flows, risk can be a matter of judgment and is subject to change
3. When risks change, so should the multiple.

D: Private capital markets – 2017 Pepperdine report

1. A survey of USA bank lenders, asset-based lenders, mezzanine lenders, private equity groups, venture capital, & angel investors, as well as business owners (mostly small)
2. Cheapest finance = bank loans
3. Most expensive finance = private angel investments
4. **Most business owners significantly underestimate the cost of equity (thus overestimate the value of their company)**

Source:

<https://bschool.pepperdine.edu/about/people/faculty/appliedresearch/research/pcmsurvey/>

Table 2: Suppliers of finance required rates of return
(ex-Pepperdine study)

Required rate of return	1 st quartile	Median	3 rd quartile
Loans \$1M-\$5M	5%	6%	8%
Asset based loans \$1M-\$5M	9%	12%	15%
Mezzanine finance \$1M-\$5M (e.g. cash flow loans)	15%	20%	25%
Private Equity \$1M-\$5M	21%	26%	34%
VC (early-expansion)	15%	25%	50%
Angel (expansion-late)	30%	35%	45%

Table 3: Business owners' estimate of cost of equity
(ex-Pepperdine study)

% owners	Cumulative owners %	Estimate of Cost of Equity
31%	31%	< 9%
19%	50%	9% - 10%
19%	69%	11% - 16%
15%	84%*	17% - 24%
7%	91%	25% - 30%
3%	94%	31% - 40%
1%	95%	41% - 50%
3%	100%	50% - 100% +

*The table suggests that 84% of owners believe that their cost of equity is less than 25%. Compare this to the expectations of the suppliers of finance (table 2).