

# **The ESOP Association: New South Chapter Fall Conference October 5<sup>th</sup> and 6<sup>th</sup>, 2011 Atlanta, Georgia**

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## **“Economic and Market Impact on Upcoming Year-End Valuations”**

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# Agenda

- **Valuation Approach Overview**
- **Recent Financial Markets Overview**
- **Recent Economic Overview**
- **Relevance and Potential Impact on ESOP Valuations Related to the Recent Economic and Financial Markets**
- **ESOP Valuation Technical Topic – Treatment of ESOP Contribution Expense in a Valuation**



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# Valuation Approach Overview...

# Three Approaches to Valuation

## Income Approach

### Common Methodologies

- Discounted Cash Flow
- Capitalized Earnings
- Capitalized Cash Flow

### Overview of Approach

- Based upon the fundamental premise that value of the business is a function of the economic income it can generate
- Most methods based upon capitalization of expected future economic income at an appropriate rate that captures the relative riskiness of the investment and the current economic environment

## Market Approach

### Common Methodologies

- Comparable Public Companies
- Comparable Transactions (M&A)
- Prior Transactions in Company Stock

### Overview of Approach

- Based on prices determined and tested by the marketplace
- Estimates the value of the business based upon evidence of prices investors are willing to pay for companies in similar lines of businesses

## Asset Approach

### Common Methodologies

- Liquidation Value Analysis
- Net Asset Value

### Overview of Approach

- Based upon the Company's financial condition
- Focus on value of underlying assets (inventory, receivables, property & equipment, etc.) rather than cash flows generated by such assets





# What Impacts the Value of a Company?

- $V = CF / R$  or  $CF \times M$ , where:
  - $V = \text{Value}$
  - $CF = \text{Future Cash Flow}$
  - $R = \text{Required Rate of Return (adjusted for growth potential)}$
  - $M = \text{Multiple (1 / Required Rate of Return)}$
- There is no single “value” of a company. Value changes over time and is subject to many influences, including:
  - Economic conditions
  - Industry performance
  - Marketplace trends
  - Company-specific attributes
- All but the company-specific attributes are largely out of the control of the business owner(s), management, and the employees



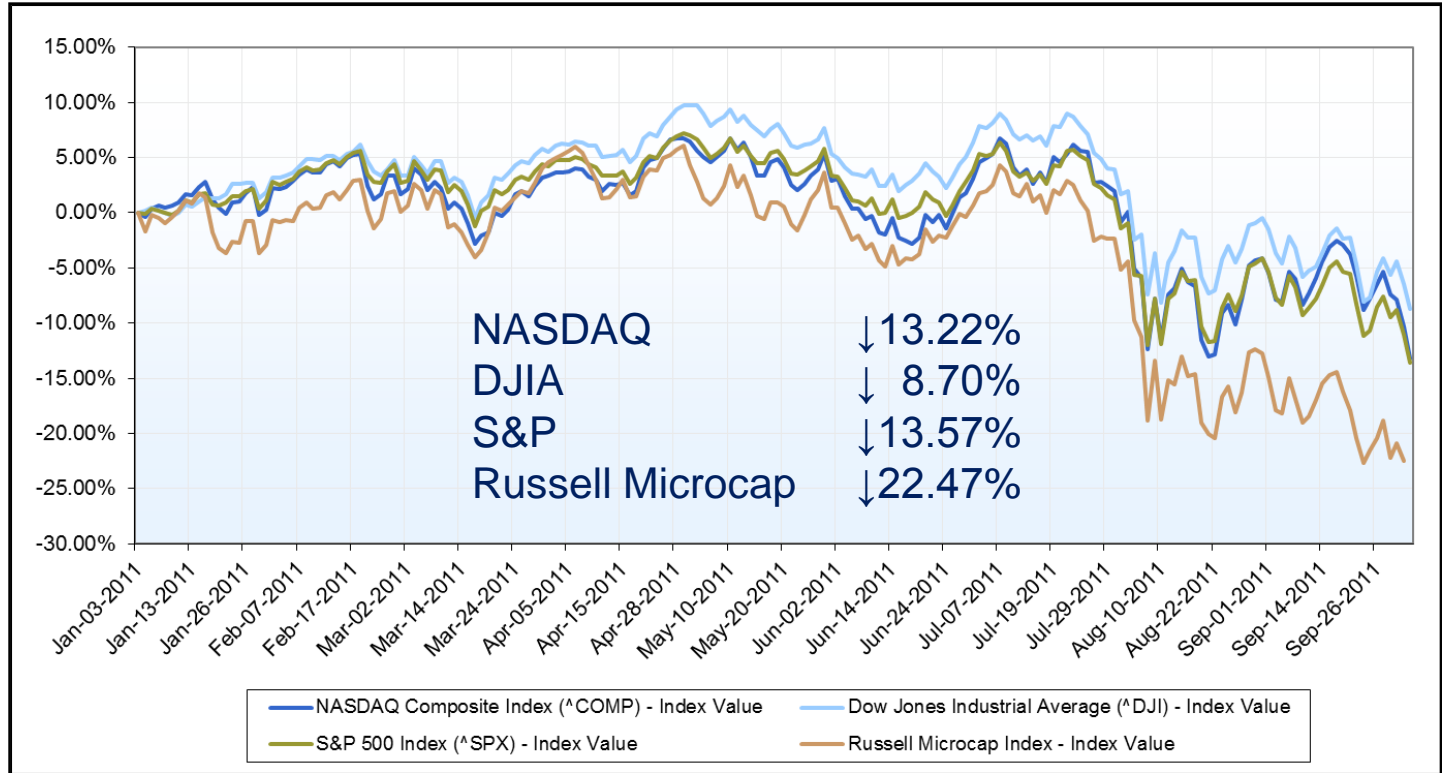
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# Recent Financial Markets Overview...

# Year-to-Date Stock Market Performance



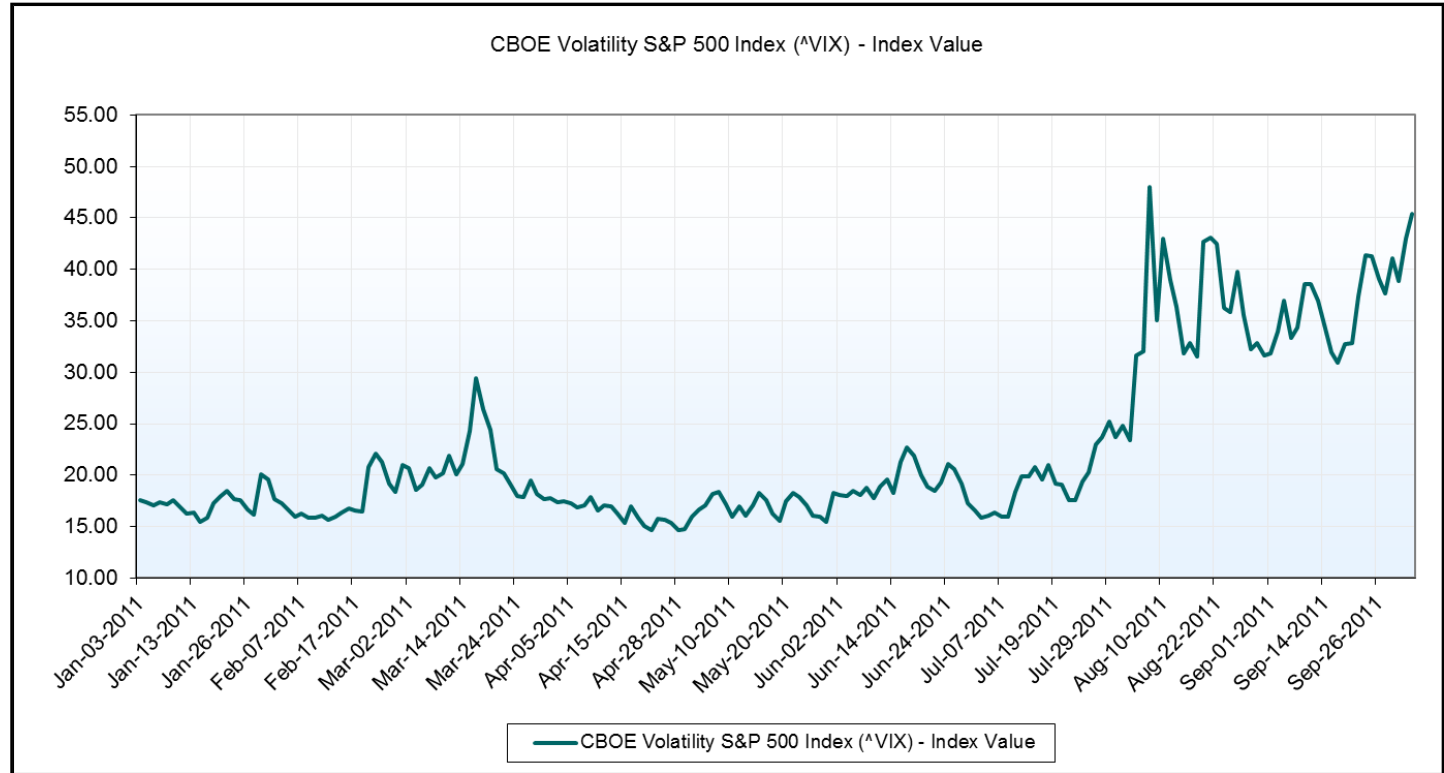
## Potential ESOP Valuation Impact:

- Possibly lower pricing multiples in the guideline publicly traded company method
- Decrease in ESOP sponsor company share price
- Certain cyclical industries will be impacted the most





# Increased Volatility in the Stock Market



## Potential ESOP Valuation Impact:

- Indicates increased perception of risk, especially during last two months
- If volatility increases It may be appropriate to place more weight on DCF method
- May impact betas



# M&A Market Factors: 2011 BOY Predictions

- Strategic buyers to stay active and accelerate sales and earnings in a low organic growth environment
- Window of opportunity for financial buyers focused on deploying large amount of committed capital (estimated at over \$400 billion)
- Modest economic growth projections with a lessening risk of a double-dip recession has increased the confidence of corporate leaders
- Credit markets are key with an increasingly favorable financing market dampened by concern over sovereign debt woes and overheating in high-yield debt
- Deal momentum begun last year will continue to be supported by positive market activities

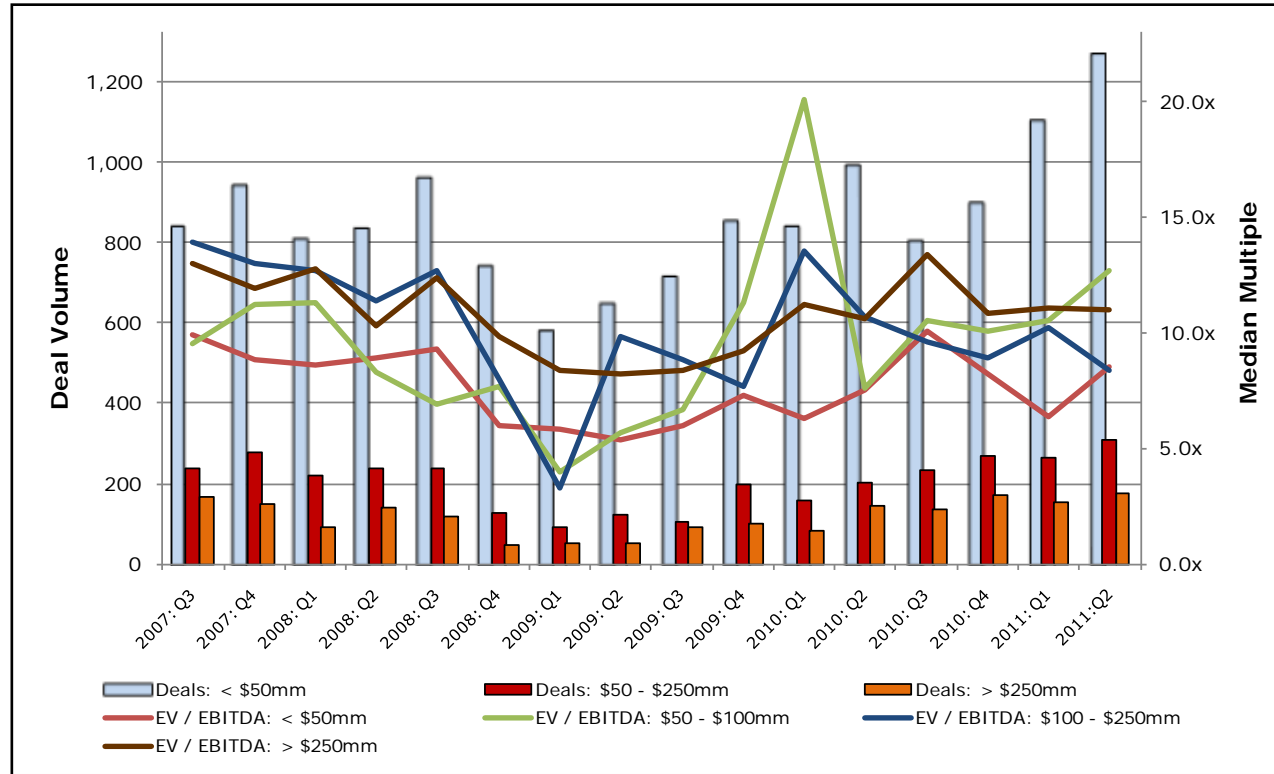
Trends

U.S. Market Indicators

	Past	Present	Future
Stock Market	↘	↗	↔
Economic Environment	↘	↔	↗
Interest Rates	↘	↔	↗
Credit Market Strength	↘	↗	↗
Geopolitical Situation	↔	↔	↘
US Politics	↔	↔	↔
Bankruptcies	↗	↘	↘
Shareholder Activism	↗	↔	↔
CEO Confidence	↘	↗	↗
Investor Confidence	↘	↗	↗
Valuation	↘	↗	↗
3 Year Outlook	↘	↗	↗

Source: Robert W. Baird 2011

# M&A Activity and Trends



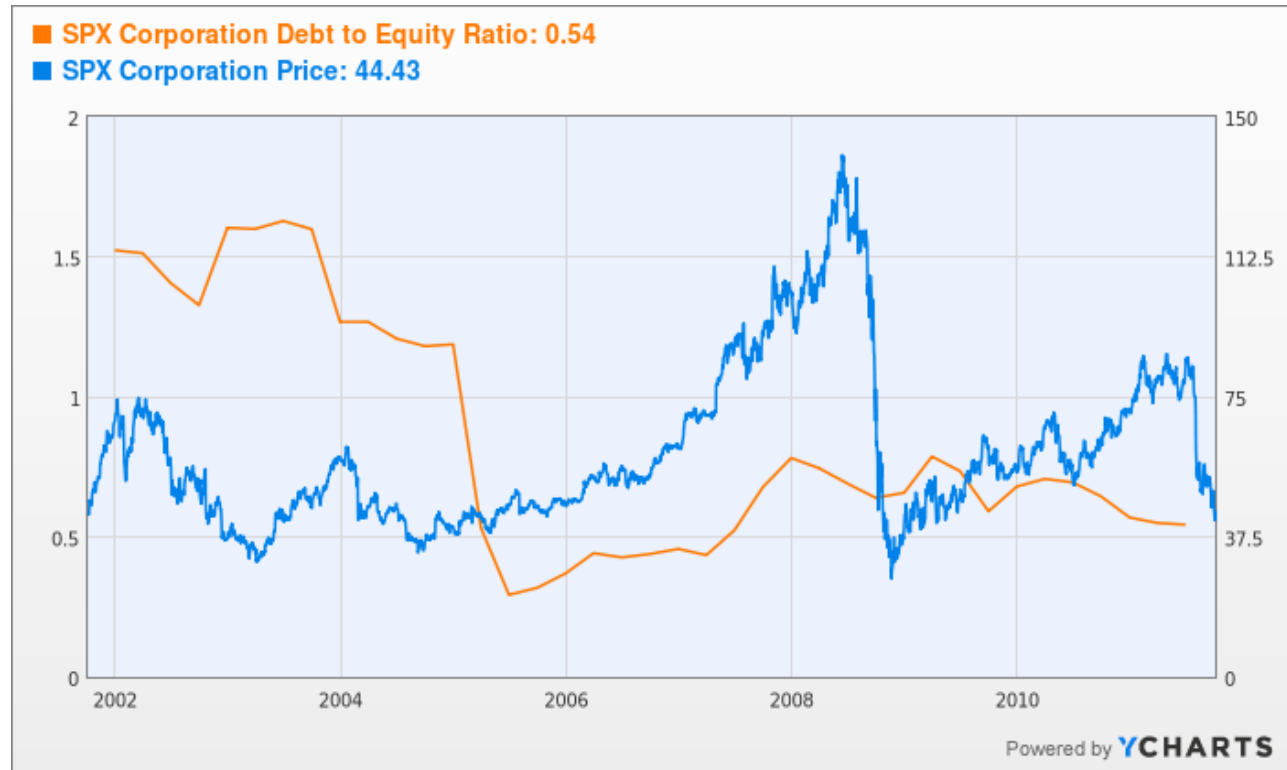
## Potential ESOP Valuation Impact:

- Transaction volume slowly trending upward; multiples are erratic but up from 2009
- Low organic growth plus available PEG / corporate cash should prompt more demand
- Concern remains over availability of financing and double-dip recession





# Leverage Trend



## Potential ESOP Valuation Impact:

- Lower debt-to-equity ratio may indicate capacity for more debt and ↓ discount rate
- Lower debt-to-equity ratios also support lower default rates and less overall risk
- Unfortunately, consumer debt levels are still high, constraining corporate growth



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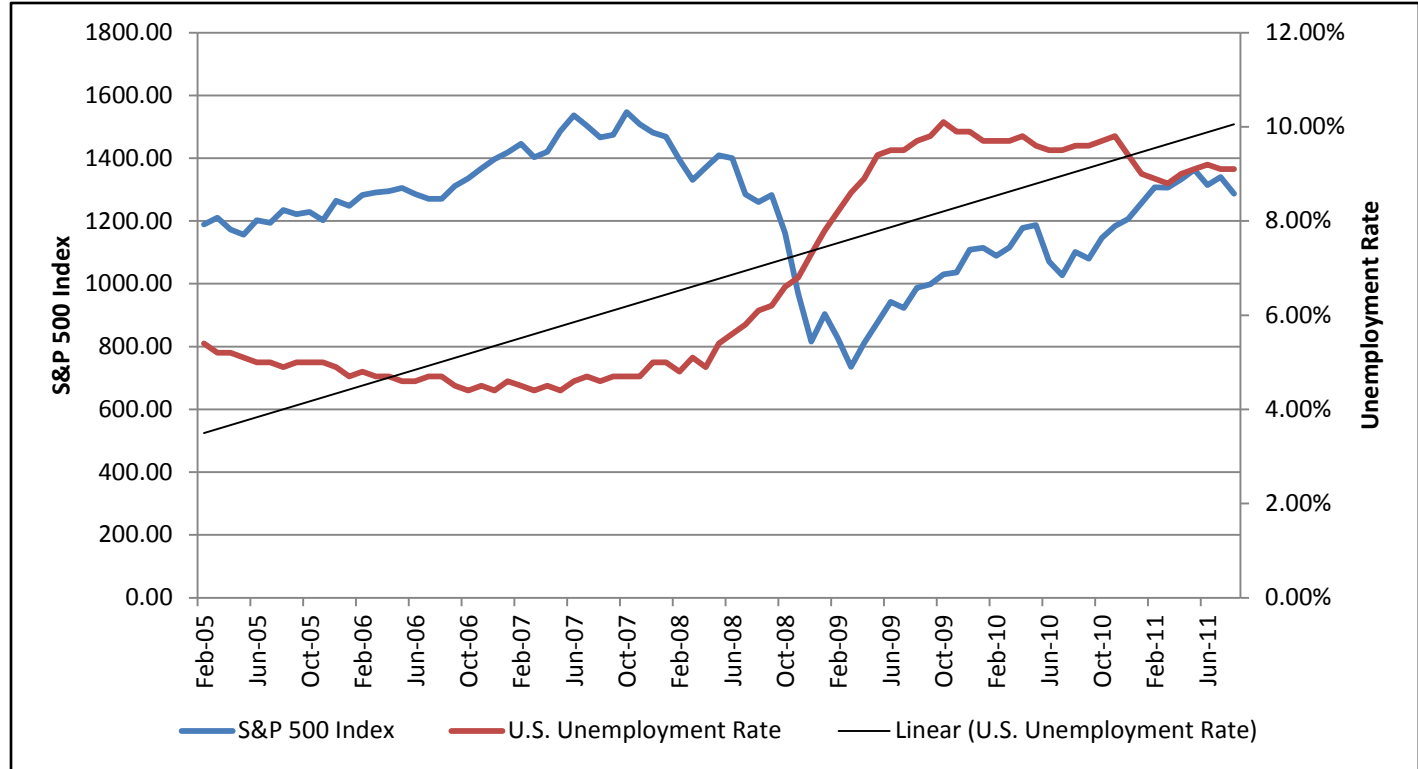
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## Recent Economic Overview...



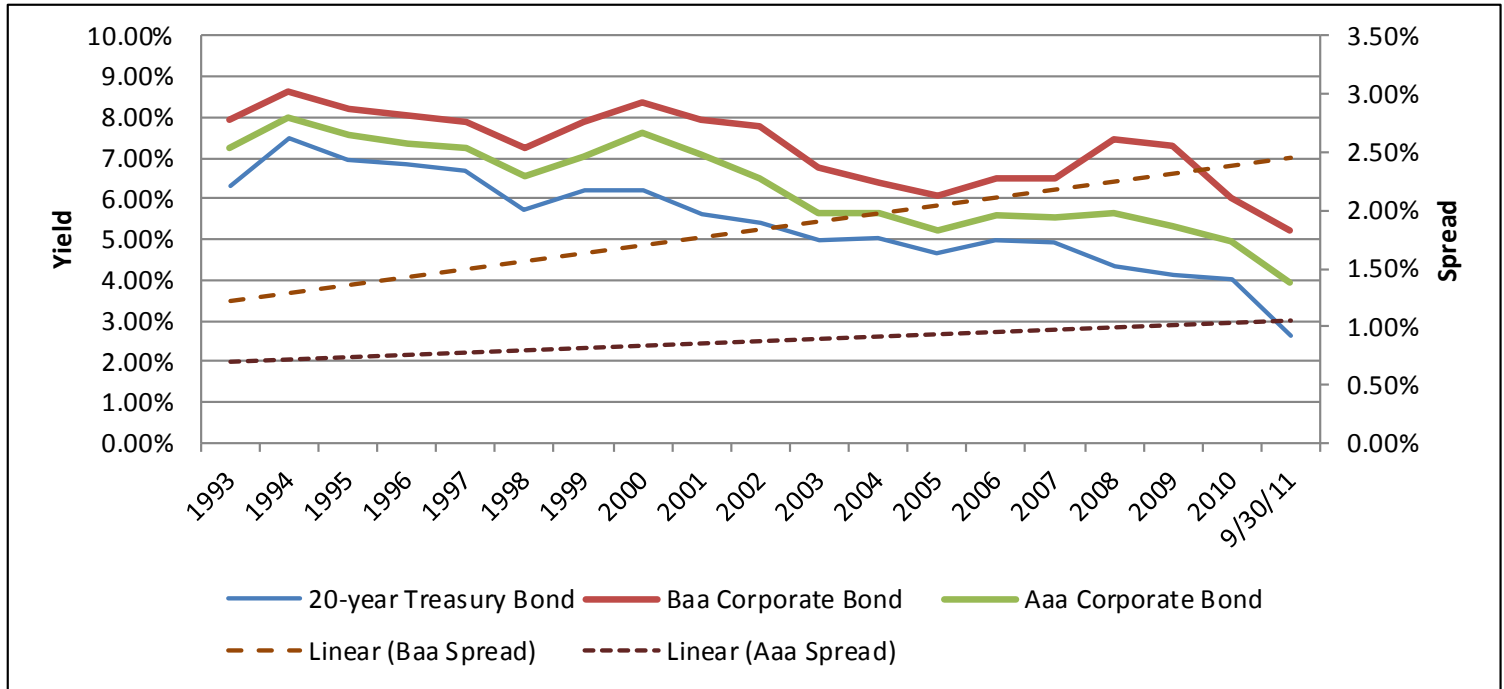
# Unemployment Rate



## Potential ESOP Valuation Impact:

- Current unemployment rate of 9.1% vs. historical average of 5.7% = ↑ risk
- Generally, equity indices and unemployment rates are inversely related
- Consumer spending accounts for 2/3 of the U.S. economy, which may ↓ value

# Interest Rate Trends



## Potential ESOP Valuation Impact:

- Greater spread between Treasury and corporate yields indicates ↑ risk, ↓ value
- On a positive note (may be / may be not), interest rates remain low, the Fed reported easing of loan standards for commercial borrowers, default rates lower
- Lower rates may reduce discount rate and may lead to ↑ M&A demand





# Domestic Deficit and Credit Risk

- This “crisis” differed from the September 2008 downturn. The market had time to prepare and accumulate liquidity to weather the storm.
- Only a small band-aid was applied at August 2<sup>nd</sup> deadline
- Most recent deficit reduction agreement will have minimal impact
- “Spending Cuts” aren’t really “cuts”. Government spending still increasing significantly every year, just at a slightly lower rate
- “Spending Cuts” are over a ten year time period, with most of the “cuts” on the back end. Nothing to hold future Congresses to these “cuts”



## Domestic Deficit and Credit Risk (cont.)

- The Joint Select Committee on Deficit Reduction (aka, the “Super Committee”) plan is due November 23 and will likely address unemployment, income taxes, payroll taxes, tax credits, entitlement programs, etc.
- The Super Committee will also be tasked with balancing its recommendations with potential passage of American Jobs Act
- Bernanke on 10/4/11: Economic recovery is “close to faltering.”
- Warren Buffett – “I could end the deficit in five minutes. You just pass a law that says anytime there is a deficit of more than 3% of GDP all sitting member of Congress are ineligible for re-election.”

### Potential ESOP Valuation Impact:

- Still too early to tell what impact there will be, if any
- S&P apparently perceives incremental risk and we may have additional qualitative and/or quantitative factors to consider as end-of-year update season approaches



# Foreign Credit Risk

- Where do we begin?
- Global bond issuance declined 36% in August to the lowest level in more than a year
- Four major international stock indices (plus the S&P 500) dropped by 10% during August
- Japan's and Italy's credit ratings dropped
- India has flirted with possible downgrade on several occasions
- Continuing European credit crises could impact U.S. and U.S. companies in several ways:
  - U.S. \$ ↑ 5.5% against € in September
  - Disparate trade (Europe accounts for 22.5% of U.S. exports)
  - U.S. also exports to other countries that service Europe
  - Value of U.S.'s European loan portfolio would continue to ↓



## Foreign Credit Risk (cont.)

- Global all-industry purchasing managers index for August was the lowest month of expansion in more than two years with manufacturing showing its first decline since May 2009
- The composite leading indicator of the Organisation of Economic Co-operation and Development declined for the fourth straight month, reaching a 17-month low
- The International Monetary Fund lowered GDP growth projections for 2011-2012
- The global M&A market has shown a year-to-date decrease in deal count of 4.0% but deal dollars have increased 17.0%

### Potential ESOP Valuation Impact:

- Similar to the U.S., we will have to wait to see what transpires, but it appears there is additional risk to companies that rely heavily on international trade
- Higher relative value for the U.S. \$ could also yield more purchases of foreign goods and services rather than domestic



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# Relevance and Potential Impact on ESOP Valuations Related to the Recent Economic and Financial Markets...



# Impact on Discounted Cash Flow Method

- Review subject company historical budgets vs. actual
- Analyze subject company's projected growth and profitability assumptions relative to industry
- The discount rate should reflect the subject company's risk in attaining its projections based upon anticipated economic and industry conditions
- There may be changes in the subject company's weighted average cost of capital (WACC)
  - Cost of equity capital
  - Cost of debt capital



# Impact on Cost of Equity Capital

- Higher volatility indicates higher risk
- All else equal, higher risk indicates higher required returns
- However, historically, there are lower returns in periods of high volatility, which means lower expected returns
- Could be significant changes in betas from prior year. May want to consider measuring various times periods
- Impact on equity risk premiums
- Small stock premium is decreasing
- Unsystematic risk premium depends on individual risks of subject company and its projected cash flows
- Equity capital structure weighting may decrease. Although a long term capital structure perspective may be more appropriate
- Remember: Similar thought process is applied to multiples selection in M&A and guideline public company analyses



# Treatment of ESOP Contribution Expense in a Valuation...



# ESOP Contribution Expense Background

- AICPA SOP 93-6 – compensation/benefit expense is based on the fair value of the shares released
- Expense related to ESOP contribution actually hits the income statement twice: First, cash contribution used to pay interest on ESOP increases interest expense. Second, the release of shares related to the cash contribution increases compensation/benefit expense



# Contribution Expense Fluctuation

- Even if company makes the same cash contribution amount each year, the expense related to the ESOP contribution could fluctuate significantly based on fluctuations in the share price
- Prepayment of ESOP debt principal can significantly increase ESOP contribution expense



# Treatment of Contribution Expense

- There is not a definitive answer for how to treat ESOP contribution expense in a valuation
- Analyst judgment based on the specific characteristics of the subject ESOP sponsor company
- Analyst's decisions on treatment of ESOP contribution expense have a direct and quantifiable impact on the valuation analysis of the ESOP sponsor company stock



# Three Ways to Treat Contribution Expense

- Method 1 – Add back the entire ESOP contribution expense (and other benefit expenses) and then subtract a market level of benefits
- Method 2 – Use management’s target or optimal ESOP contribution amount
- Method 3 – Make no or few adjustments and keep as-is or close to as-is

# Example: Contribution Expense Adjustment

	Fiscal Years Ended December 31:				
	2010	2009	2008	2007	2006
	\$000	\$000	\$000	\$000	\$000
Reported Pretax Income	12,224	3,064	33,104	64,847	15,984
<u>Adjustments to Pretax Income:</u>					
Add back: ESOP Contribution Expense	9,877	3,513	19,232	8,636	8,721
Deduct: Normalized Retirement Expense	<u>(3,450)</u>	<u>(2,901)</u>	<u>(5,788)</u>	<u>(4,458)</u>	<u>(3,160)</u>
<b>Adjusted Pretax Income</b>	18,650	3,676	46,548	69,025	21,545





# Sources to Estimate Market Level Benefit

- Company's historical level of benefits prior to the ESOP
- Guideline publicly traded company SEC filings – May contain detailed information on retirement plan benefit expense
- U.S. Department of Labor – Bureau of Labor Statistics website  
[www.bls.gov/ect/](http://www.bls.gov/ect/)
- Industry specific publications