What Makes a Good Forecast Good?

Illinois Chapter of the ESOP Association
Winter Conference
March 9, 2017
Why Are We Here?

- As frequent creators, users and reviewers of forecast, the panelists see a wide range of forecast models, output and technique.

- Our goal today is to share best practices as we see them in the marketplace

The “Marketplace” of Forecast Users

- Banks
  - Credit decisions & monitoring

- ESOP Trustees & their advisors
  - Valuation

- Corporate Management
  - Strategic planning
  - Repurchase liability considerations
What does this forecast tell me:

- About the company & its outlook
  - About management
- About its cash flow drivers
  - Working capital needs
  - Fixed capital reinvestment
  - Dividend policy
### Appropriate Level of Detail

#### For the intended user

- **The other extreme** – Too much “insignificant” data for the intended user.

**Forecast $2,731 of Temporary Labor on aggregate revenues of $21,299,717**
• Forecast must include synchronized Balance Sheet, P&L, and Cash Flow

• Forecast statement presentation consistent with GAAP
  • If reflecting an “internal” presentation format, can you bridge to GAAP?

• Assumption Summary identifies critical variables and your approach to forecasting each
  • i.e. Forecast % Sales growth vs $ annual growth in sales
  • i.e. Forecast Inventory turns vs. absolute $ inventory

• Support traditional 3 statements with appropriate analytics & trend analysis
  • EBITDA and EBITDA Margin
  • SFD / EBITDA
  • Fixed Charge Coverage
  • What do you measure?

• If supporting detail is helpful, include it as an addendum
  • i.e. Growth vs. Maintenance CAPEX
  • i.e. Commodity Price / Volume Analysis
  • i.e. Product Mix or Domestic vs International Detail
Your forecast is often a critical part of the bank’s underwriting process

Can your banker communicate the forecast internally?

- Basis for assumptions
- Rationale for significant changes in historical and forecast results
  - Rationale for significant assumption variance from industry norms
- Certainty / achievability
- Sensitivity of results to forecast variables
  - Upside / Base Case / Downside forecast
  - Demonstrate covenant compliance and ability to service debt under each
  - Management options in the downside
- Anticipation of “other” claims
  - Seller note repayment / refinancing
  - Warrant payout
  - Repurchase Liability

In the event of a forecast “miss” the lender will seek to understand the situation with a forward looking emphasis on next steps & how he gets repaid
Your forecast is a critical part of the transaction valuation and the trustee’s annual update

Supported by its advisor, your trustee is an “equity” investor with no secondary exit
  • As such the trustee’s due diligence is often somewhat more in-depth

Can your trustee communicate your forecast – *after the fact ... to the DOL?*
  • Basis for assumptions
  • Rationale for significant changes in historical and forecast results
    - Rationale for significant assumption variance from industry norms
  • Relative certainty of results may drive the appropriate discount rate
  • Have you considered value growth trajectory and repurchase liability?

In the event of a forecast “miss” the DOL may seek to understand the situation with an emphasis on what went wrong & should/could it have been anticipated in the valuation
  • Documentation of assumption rationale – at the time the assumption was made - is critical
    - Documentation equally important for the internal and external trustee
What you see above the line is just the ‘tip of the iceberg’ relative to the mass of interconnected factors that ultimately drive results.

Forecasts often reflect either the ‘most likely’ or ‘best case’ outcomes. Understanding the difference is important for management and for the users of the forecast.

Understand what it will take to make it and what it would take to break it. Anticipate and Mitigate.
User Application – Management
The Good Forecast is the Basis for Strategic Planning & Value Enhancement

How Value Drivers Link to Value Creation

- GROWTH DRIVERS → Invest in Value-Creating Growth Opportunities
- EFFICIENCY DRIVERS → Invest in Operating Efficiency, Divest of Value Destroying Activities
- FINANCIAL DRIVERS → Reduce Cost of Capital
Relating Value Drivers to your Company’s Valuation

Discounted Cash Flow, often the primary tool employed in ESOP Valuation, is wholly dependent on Free Cash Flow generation.

In support of the strategic plan, a good forecast:

✓ Tests the sensitivity of drivers on free cash flow (FCF)
✓ Prioritizes cash flow / value-creating activities
✓ Anticipates the impact on your FCF from changes in key drivers
✓ Drives strategies and policies that increase free cash flow and ultimately value
Example: Capital Intensive Business

Basic Assumptions:
Status Quo 5-year Cumulative Free Cash Flow: $16MM
Status Quo Value: $20MM
You have $1MM to invest in strategic initiative

A Good Forecast illustrates where you get the biggest bang for your buck

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<thead>
<tr>
<th>Lever</th>
<th>Status-Quo</th>
<th>Change</th>
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<tbody>
<tr>
<td>Revenue Growth</td>
<td>5%</td>
<td>+ 2%</td>
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<tr>
<td>Operating Profit Margin</td>
<td>20%</td>
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<td>A/R Days Outstanding</td>
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<td>Days in Inventory</td>
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<td>-25 days</td>
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<tr>
<td>Combo: Profit Margin</td>
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<td>+0.5%</td>
</tr>
<tr>
<td>Days in Inventory</td>
<td></td>
<td>-20 days</td>
</tr>
</tbody>
</table>
Example: Capital Intensive Business

Where do your forecast alternatives suggest you invest?

Cumulative FCF / Valuation Sensitivity

- Improve Revenue Growth
- Improve Profitability: 6.1%
- Improve DSO: 8.4%
- Improve Inventory Turns: 8.4%
- Combo Improve Profits & Inventory Turns: 12.8%
Example: Service Business

Basic Assumptions:
Status Quo 5-year Cumulative Free Cash Flow: $16MM
Status Quo Value: $20MM
You have $1MM to invest in strategic initiative

A Good Forecast illustrates where you get the biggest bang for your buck

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<tr>
<td>Operating Profit Margin</td>
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<tr>
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<td>+0.5%</td>
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User Application – Management
Alternatives Analysis in the Forecast
Example: Service Business

Where do your forecast alternatives suggest you invest?

Cumulative FCF / Valuation Sensitivity

- Improve Revenue Growth: 9.2%
- Improve Profit Margin: 6.0%
- Improve DSO: 3.7%
- Combo: Improve Margin & DSO: 7.8%
Applying a Good Forecast to Acquisition Analysis

In support of the acquisition, a good forecast:

- **Tests** the sensitivity of drivers on free cash flow (FCF)
  - **Focuses** due diligence
  - What assumptions are easy to make .... Which are more difficult?
- **Quantifies** the impact on combined FCF from changes in key drivers / synergies
- **Prioritizes** post-transaction value-creating activities
- **Brings Urgency** to post-transaction integration

Enhanced Value
The assumption set of the good acquisition forecast addresses issues and opportunities at both the Parent and the Target

- Independent Analysis of Strengths / Weaknesses
  - What is your core competency / why do you exist?
  - Who or what can replace you and your products?

- Analysis of Top Customers
  - High risk customers – who has the relationship?
  - Customer overlap / concentration issues?

- Analysis of Top Suppliers
  - Pricing power – supply opportunities?

- Analysis of Top Competitors
  - SWOT Analysis – why do customers choose the company?
  - Where are your likely opportunities … are you targeting them

- Post-transaction *Synergy* and *Synergy*
  - Ease, timing and certainty of implementation

- Organizational Chart
  - Succession planning – key dependence issues

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User Application – Management

*The Good Forecast is the Basis for Acquisition Analysis*
Practical Takeaways
What Makes a Good Forecast Good?

- Appropriate level of detail
- Communication re. the rationale for and attainability of your assumptions
  - Documentation / Contemporary support for assumption set
- Identification of and sensitivity to key forecast variables
  - Management options in the downside
- Identifies and quantifies financial opportunities
- Reflects the strategic plan
- Speaks to the audience’s needs
Panelist Bios – Julie Williams

Julie A. Williams
Managing Director
ESOP Solutions – National Lead
PNC Financial Services Co.
171 Monroe Ave. NW
Grand Rapids, MI  49503

- Direct 616-771-8864
- Cell 773-383-7252
- E-mail Julie.Williams@PNC.com

Julie Williams is Managing Director and the national lead for ESOP Solutions for PNC Bank. Julie has 15+ years of experience advising companies and business owners on various aspects of ESOP transactions. Clients and prospects of PNC leverage Julie’s knowledge and experience as they evaluate the benefits and considerations of using an ESOP as an ownership transition and liquidity solution. Julie also serves as a resource for PNC clients as they execute their corporate strategy with the added complexity of ESOP ownership.

Julie joined PNC in September 2015 after serving most recently as a SVP in JP Morgan Chase’s ESOP Advisory Group. Previously she held senior positions with Duff & Phelps and Cognient Group in Chicago, IL where she served as financial advisor for companies, institutional ESOP Trustees, and selling shareholders engaging in ESOP transactions. In addition, she served as an institutional ESOP trustee at GreatBanc Trust Company where she led negotiations for ESOP transactions involving the purchase or sale of stock or assets.

Julie received a Bachelor of Business Administration degree from the University of Michigan and holds a Master of Business Administration from the University of Chicago, Booth School of Business. She is licensed by FINRA with a Series 79 and Series 63.

Julie is a member of the ESOP Association headquartered in Washington, D.C. and serves on their Valuation Advisory Committee. She is also an active member of the National Center for Employee Ownership, Association for Corporate Growth and Economics Club of West Michigan.
Panelist Bios – Richard P. Shuma

Richard P. Shuma
Managing Director
Prairie Capital Advisors, Inc.
One Mid America Plaza, Suite 1000
Oakbrook Terrace, IL 60181

Office 630-413-5598
Cell 312-420-4228
E-mail rshuma@prairiecap.com

- Dick Shuma is a Managing Director at Prairie Capital Advisors, Inc. where he represents middle market business owners in developing and executing the “right” transition strategies. Within Prairie’s broader capabilities, he specializes in ESOP feasibility, structure and execution.

- Prior to joining Prairie, Dick spent 36 years the BMO/Harris organization. In that role Mr. Shuma represented both corporate and investment banking disciplines leading and participating in a wide range of traditional and leveraged financings for the account of the bank, strategic advisory engagements, buy and sell-side M&A engagements and various other capital raising engagements. In addition to his generalist financial advisory work, he formed and lead BMO/Harris’ ESOP specialty where he brought significant experience to many of BMO/Harris’ ESOP and Non-ESOP-owned clients.

- He is co-author of a recently published work “Here, Take the Wheel,” a unique book offering succession planning stories and insights from business owners.

- Dick has held successive terms as President of the Bankers Association for Corporate Finance, a trade group comprised of select senior management of the nation’s largest regional and super-regional banks. He has appeared as guest lecturer and panelist in the corporate finance, valuation and M&A disciplines at the University of Chicago, Northwestern University, DePaul University, and The Entrepreneurship Institute, the ESOP Association and the National Center for Employee Ownership.