

# Forecasting for ESOP Valuations in *Uncertain Times*



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# Agenda

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- Introduction/Overview
- DOL perspective on projections
- Litigation involving projections (what not to do)
- Forecasting in a COVID-19 Environment
- Benefits of preparing projections in a COVID-19 environment
- Preparing projections for ESOP purposes
- Forecasting Compensation
- Best Practices (what to do)
- Analysis of projections (and risks of projections)

# SETTING THE TABLE

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## Projections are the #1 issue in ESOP litigation

- Majority of ESOP litigation involving 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 that were known or knowable, **as of the Valuation Date\*\***
- Explicitly or implicitly relies on financial projections

# DOL PERSPECTIVE ON PROJECTIONS



## Deputy Assistant Secretary for National Office Operations

Timothy D. Hauser is the Deputy Assistant Secretary for National Office Operations and as such is the chief operating officer of the agency. Mr. Hauser closely coordinates with the Assistant Secretary, Principal Deputy Assistant Secretary, and Deputy Assistant Secretary for Regional Office Operations in the formulation and development of EBSA policies, objectives, and goals to ensure comprehensive, integrated, and effective regulatory, compliance assistance, education, reporting, and enforcement programs.

## DOL PERSPECTIVE ON PROJECTIONS cont.

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*“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

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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? How is this factored in?

Source: *Tim Hauser of the DOL*

# DOL PERSPECTIVE ON PROJECTIONS

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

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- Using financial performance estimates that are inconsistent with the actual financial performance of the company
- Aggressive and unsupported 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

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- Who is responsible for projections?
- Document 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

# COVID-19

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- Created an entirely new work paradigm, and it is essentially new territory for everyone
- Completely uncommon crisis that's not yet fully understood, and by definition, much of the outcome is not predictable
- Currently, there is no cure and sentiment is varied on how long it will take for normalcy will be redefined over time
- What is “the new normal” is something to be considered, for all businesses
- Materiality of economic impact on global economy is just a wild prediction for right now

# COVID-19

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- Forecasting with COVID-19 in mind. Factors:
  - Careful, possibly month by month, forecasting for the next fiscal year
  - If revenues change sharply, how long is that expected to persist?
  - Expectation to return to normalcy?
  - What expenses may need to be scrutinized in light of roller-coaster revenues?
  - How will the outlook on investment in company (cap-ex) change?
  - ***Generating and preserving cash flow***

\*\*May need to do 2 forecast scenarios (optimistic and pessimistic) for purposes of determining weighted average “expected cash flow”.

# COVID-19

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- Forecasting with COVID-19 in mind. Factors:
  - Strong communication with customer base
  - Supply issues
  - Working capital needs – how will receivables and payables be impacted in the short term? Careful eye on working capital.
  - Forecasting cash flow needs/and possibly increased banking needs
  - Consider repurchase needs from eligible ESOP Participants

# BENEFITS OF PREPARING PROJECTIONS

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- 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.

## BENEFITS OF FORECASTING IN LIGHT OF COVID-19

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- ESOP companies are well positioned - they are accustomed to forecasting/pondering next 12 months
- This year, wise to putting your forecasting skills to use beyond the need for complying with the ESOP update
- You may already prepare weekly/monthly forecasts (with more detail than for the ESOP update)
- If not, this is something to consider doing or requesting assistance of your CPA/financial advisor
- *Cash flow budgeting is very important in uncertain times*

# TIMING OF VALUATION: COVID-19's IMPACT ON ESOP UPDATES

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Valuation is based on methodologies that take into account factors that were known or knowable as of the Valuation Date

- This is been a hot topic in the past month due to COVID-19
- The Valuation Date is critical - most all Plans require the update valuation, as of 12/31 of each calendar year
- Can NOT factor in forecasts, or economic or industry factors that were NOT known/knowable as of December 31<sup>st</sup>
- Consider an **Interim Valuation**, after the outbreak of COVID-19, which could properly incorporate these factors (if deemed necessary)
- There are **many factors** that go into determining the necessity of obtaining an **Interim Valuation**; facts/circumstances will be the determining factor.



# PREPARING PROJECTIONS FOR ESOP PURPOSES: ROLES AND RESPONSIBILITIES

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## **Management/Financial Advisor:**

- Prepare & take responsibility for projections
- Develop support for key assumptions

## **Board:**

- Review for reasonableness before “published”
- Help management substantiate key assumptions

## **Valuation Advisor:**

- Review, understand, question & scrutinize
- Compare with past performance & industry trends
- Assess level of conservatism & aggressiveness

# PREPARING PROJECTIONS FOR ESOP PURPOSES: ROLES AND RESPONSIBILITIES

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## ESOP Trustee:

- Review, question, understand & scrutinize
- Understand valuator's analysis of projections
- Understand the risk of such projections and other aspects of company
- Ultimately approve the value conclusion based on projections and valuator assessment of them

## CPA Firm/Outside Advisor:

- Coaching on preparing financial projections for the initial ESOP transaction

# IS IT BETTER NOT TO FORECAST?

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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**

# WHY IS THE FORECAST IMPORTANT?

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- In short.... it is a driver of VALUE!
- Key component of income approach, market approach and transaction approach
- Underlying assumptions drive relative pricing

# CURRENTLY WE HAVE NO FORECAST...

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- How do you measure internal performance?
- Are there any monthly, regional or annual sales goals?
- How do you assess 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

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## 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

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## 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

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## 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?



# FORECASTING COMPENSATION

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- **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

## COMPENSATION ISSUES IN LITIGATION

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- 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 – normalized health benefits despite no plans to change post-transaction

# Best Practices

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- Board involvement and approval
- Narrative and part of overall strategic plan
- Collective input
- Post-mortem analysis
- Comparison to historical, industry, and overall economy
- Multi-year
  - Prepared quarterly
  - Projected financial statements - income statement, balance sheet, cash flow statement

# ANALYSIS OF PROJECTIONS (and Risks of Projections)

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## 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 (and Risks of Projections)

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- 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 (and Risks of Projections)

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

# ANALYSIS OF PROJECTIONS (and Risks of Projections)

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

# ANALYSIS OF PROJECTIONS (and Risks of Projections)

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- 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



# ANNUAL UPDATE VS. INITIAL TRANSACTION

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## 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

# RISK ISSUES WITH PROJECTIONS – ESOP TRANSACTIONS

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- 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

# FORECASTS IN LIGHT OF DOL SCRUTINY

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DOL Audits are part of being an ESOP

Documentation is key!

Hindsight is 20/20 – what are you doing to capture your business judgment today?

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
- The best defense is a good offense (credible report and analysis)

## Frank “Chip” Brown CFA, CPA/ABV/CFF, CVA

### Senior Vice President, Employee Benefits Group

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Chip’s past work experience includes providing valuation and transaction financial advisory services as a managing director for a national valuation firm where he served as the firm’s ESOP practice leader. These services included fairness opinions, solvency opinions, fair market valuations, and other financial advisory opinions to various parties, including ESOP fiduciaries. Chip has served an expert witness in state and federal court on a variety of matters pertaining to valuation and economic damages. He is an active member of The ESOP Association and the National Center for Employee Ownership. He has authored numerous articles, book chapters, and presentations related to ESOPs.

#### Education

- Georgia Institute of Technology - BS Management
- Virginia – MS Accounting

#### Professional & Civic Affiliations

Charter Financial Analyst (CFA) Institute  
American Institute of Certified Public Accountants  
ESOP Association — Valuation Advisory Committee  
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# Patrice Radogna, ASA, CPA, ABAR

## Director – Valuation & Litigation Support

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Patrice Radogna is a director within the Valuation and Litigation Services Advisory Practice. Ms. Radogna has more than 20 years of professional services experience specializing in the valuation of operating businesses and pass-through entities for a myriad of purposes. Her experience also includes providing fiduciary services for ESOP (Employee Stock Ownership Plan) companies, including assisting in buy transactions from existing shareholders.

Prior to her current role Ms. Radogna spent 20 years building a national diversified valuation practice with a boutique valuation firm in Boston, as well as one of the leading independent national valuation firms in the U.S., with a focus in the areas of ESOP (buy-side and sell-side valuation services), gift and estate, M&A and shareholder consulting services. Prior to working in the valuation field, Patrice spent three years as a financial underwriter for a surety company, working with contractors in New York City.

Ms. Radogna has attended more than 600 continuing professional education credit hours in specialized valuation-related courses, seminars, and conferences and is a frequent speaker for industry groups on issues such as employee stock ownership plans and valuation-related topics. She has also authored numerous articles in industry publications and is a contributor to Marcum's Quarterly ESOP update publication.

### Education

- Boston College - BS Finance
- New York University, Leonard N. Stern School of Business – Certificate of Accounting

### Professional & Civic Affiliations

American Institute of Certified Public Accountants (AICPA)  
American Society of Appraisers (ASA)  
The ESOP Association  
National Center for Employee Ownership  
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# Dan Markowitz, CPA

## Partner

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Dan is the leader of the Boulay's ESOP practice. He specializes in audit and other financial reporting engagements for public, private and ESOP-owned clients in a variety of industries including retail, engineering, professional services, real estate, and manufacturing and distribution. Dan analyzes business operations to provide recommendations for enhancing overall business performance, and he provides financial and consulting services to ESOP companies, including ESOP feasibility studies, ESOP sustainability projects, repurchase obligation studies, and managing annual ESOP administration. Dan also leads the due diligence team in evaluating the financial and operational reporting system of acquisition target companies, and he assists clients with merger and acquisition activities, including deal structuring, tax impact of transaction, and quality of earnings reports.

### Education

- Utica College Masters of Business Administration - Economic and Fraud Management
- The Pennsylvania State University - B.A. in Accounting

### Professional and Civic Affiliations

- Minnesota Society of Certified Public Accountants
- American Institute of Certified Public Accountants
- ESOP Association — Member
- Employee-owned S-Corporations of America (ESCA) — Member
- Minnesota Retailers Association — Board of Directors
- National Center for Employee Ownership — Member



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# Questions?

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