Planning for the Transition

Presentation Prepared For

The Dayton Accounting Show

May 18-19, 2011

Presentation by:

James S. Hollander

Managing Director

Corporate Development Associates, Inc.

Today’s Discussion

- Exit Planning Overview
- Business Valuation
- What Drives Value
- Determining a Company’s DCF Value
- Factors to Improve a Business’ Value
- How to Realize the Value of a Business

What is Exit Planning

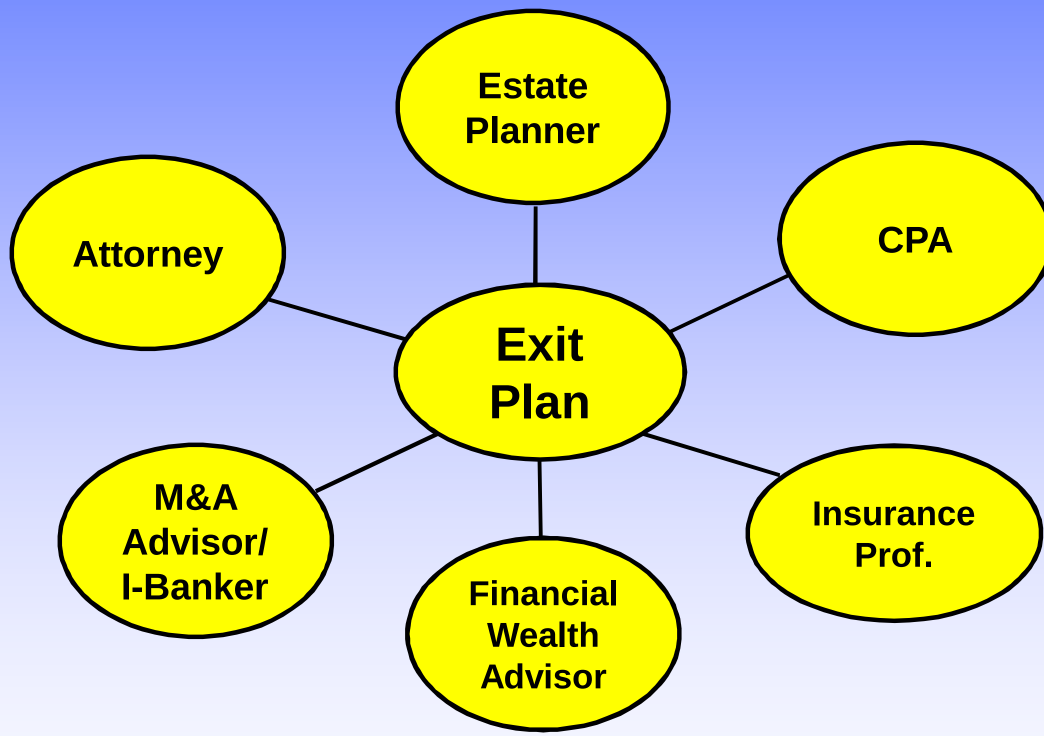
- Exit planning is a highly personal process and there is no off-the-shelf solution that is right for everyone.
  - Business owners need to embrace it and determine how they feel comfortable addressing it
- It basically considers four issues:
  1. When do I/we want to leave the business?
  2. What will be the level of my financial security for me and my family?
  3. Who should get the business?
  4. How will the above get accomplished?
- It should take into consideration all the various stakeholders
  1. **Primary:** shareholders, spouses, children, in-laws, key management
  2. **Secondary:** employees, customers, suppliers, community

Benefits of Exit Planning

- *"Every moment in planning saves three or four in execution"*
  - Crawford Greenwalt – former CEO of DuPont Company
- It provides a sense of security or peace of mind when you have thought it through, *"This is where I am at today, and this is where I want to be."*
- Reduces employee and family uncertainty -- preserves family harmony
- Evaluate the strategic exit options – family, employee, third-party, liquidate
- Maximize the value of the business by preparing or positioning it for transition

Exit Planning Advisory Team

- There should be a multidisciplinary advisory team
  - One of members on the team generally drives or manages the process for the owner(s)



"A wise man will hear and increase in learning, and a man of understanding will acquire wise counsel."

Exit Planning Process

- **The Exit Planning Advisory Team** meets to *first* develop a plan and then meets annually to review and adjust the plan until it is implemented. Ideally it should be a written plan consolidated into one binder.

1. Owners personal objectives and dreams
2. Personal financial plan and retirement needs analysis
3. **Determination of current value of business**
4. **Plans to improve value of business**
5. **Business exit strategy and plan**
   (should also develop "hit by a bus" scenario)
6. Estate Plan
7. Tax minimizations strategies
8. Insurance needs
9. Investment plans with proceeds from sale
10. Pre due diligence review

Activity	No. of Months Low	No. of Months High
Prepare Exit Plan	6	12
Implementation of Value Enhancement and Tax Planning	12	24
Sale/Transition of Business	6	12
Transition involvement	6	24
Total Months	**30**	**72**
Years	**2.5**	**6.0**

Why Understand Business Value?

- To understand the value of this asset today and where it needs to grow to meet your retirement objectives.
- Creates a value mind-set in an organization
  - Have we improved the value of the business over time and by how much?
- Allows management to evaluate the implications of pursuing various strategies with an objective risk-reward methodology.
- Management compensation system – pay for improving value, not status quo.
- Management is prepared to deal with potential interested buyers
  - Offer to good to refuse
- Examine the implications of an acquisition

Business Value

- The investment banking community focuses on Enterprise Value **(EV)**.

- EV is defined as the value attributed to net operating assets of the business independent of its capital structure.
  - – Standardize valuation from which the market evaluates operating results
  - – Market valuation statistics e.g. multiples of EBIT[1], EBITDA[1], revenues

- For a public company the EV is typically defined:
  - \+ Market value of the common stock
  - \+ Market value of preferred stock
  - \+ Market value of debt
  - – Cash and equivalents and other non-operating assets

[1] **EBIT** = **E**arnings **B**efore **I**nterest and **T**axes **EBITDA** = **E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortization

What drives the EV?

- **Underlying value of the assets**
  - It is the <u>base</u> value of a business
  - If the business is only worth the value of the underlying assets, management has been ineffective in managing the business and/or they are operating in a very competitive market

- **Expected cash flow generated by the business**
  - Predictable/maintainable/definable ← **Key cash flow attributes**
    - Customer or Supplier Diversity
    - Industry concentration/diversity
  - Trend – up, down, or level
  - Capital expenditure and working capital needs
  - Return on invested capital – **excess over minimum EBIT**

Enterprise Value Driver – Cash Flow or Assets?

(000's)	Cintas	Standard Register
Latest Twelve Months (LTM)	02/28/11	04/03/11
Revenues	$ 3,707,700	$ 665,800
EBIT	410,000	11,600
% of Revenues	11.1%	1.7%
EBITDA	601,500	34,600
% of Revenues	16.2%	5.2%
Enterprise Value		
Cash/Investments	$ (184,700)	$ 600
Total Debt	808,100	38,300
Preferred Stock	-	-
Common Equity	4,495,582	101,724
Enterprise Value (EV)	$ 5,118,982	$ 140,624
Net Assets Employed	$ 3,332,900	$ 279,400
EBIT/Net Assets Emp.	12.3%	4.2%
Tangible Net Assets Employed	1,720,400	169,800
EBIT/Tangible Net Assets Emp.	23.8%	6.8%
Market Valuation Statistics:		
EV/EBIT	12.5X	12.1X
EV/EBITDA	8.5X	4.1X
EV/Revenues	1.4X	0.2X
EV/Tangible Net Assets Employ	3.0X	0.8X
EV/Net Assets Employed	1.5X	0.5X
Stock Price/Book Value	1.8X	2.1X

Enterprise Value Driver - Trends

		Cintas	Standard Register
Revenues	LTM	$ 3,707,700	$ 665,800
	2010	3,547,300	668,400
	2009	3,774,700	694,000
	2008	3,937,900	791,100
EBIT	LTM	$ 410,000	$ 11,600
	2010	411,500	9,800
	2009	495,700	12,800
	2008	577,500	21,700
EBIT % of Revenues	LTM	11.1%	1.7%
	2010	11.6%	1.5%
	2009	13.1%	1.8%
	2008	14.7%	2.7%
EBITDA	LTM	$ 601,500	$ 34,600
	2010	604,600	33,000
	2009	695,800	37,400
	2008	769,400	47,600
EBITDA % of Revenues	LTM	16.2%	5.2%
	2010	17.0%	4.9%
	2009	18.4%	5.4%
	2008	19.5%	6.0%

Determining the EV of a Company

1. Prepare a strategic plan
2. Develop a long-term financial forecast – worse, expected, and best case scenario
3. Ideally develop a forecast on each strategic business unit within the company
4. Apply the discounted cash flow (DCF) methodology to future cash flows to determine the enterprise value of various scenario.
5. If the DCF value is not significantly above the estimated fair market value of its net assets employed, then an appraisal of the company assets should be secured (both fair market value in-place and orderly liquidation value).

Let's go thru an illustration of XYZ Company

Enterprise Value via DCF Model

XYZ Company | **Dayton Acctg. Show Illustration**

Income Statement
(000's)

		Actual			Projections				
		Y/E Dec. 31			Years Ending Dec. 31:				
		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
Incomes Statement									
Net Sales		$ 41,000	$ 38,000	$ 40,000	$ 42,000	$ 44,100	$ 46,305	$ 48,620	$ 51,051
Cost of Goods Sold		30,400	28,880	29,600	31,974	33,569	35,244	37,003	38,850
Gross Profit		10,600	9,120	10,400	10,026	10,531	11,061	11,617	12,201
SG&A		2,000	1,800	1,900	1,948	1,996	2,046	2,097	2,150
Income From Operations		$ 8,600	$ 7,320	$ 8,500	8,078	8,534	9,014	9,520	10,052
Other Expense (Income)					-	-	-	-	-
Interest Expense (Income)					155	187	219	237	240
Earnings Before Taxes					7,924	8,347	8,795	9,283	9,812
Income Taxes	40%				3,116	3,286	3,465	3,660	3,872
Net Income					$ 4,808	$ 5,062	$ 5,331	$ 5,623	$ 5,941
Depreciation & Amort.		$ 613	$ 633	$ 653	$ 684	$ 715	$ 747	$ 781	$ 817
EBITDA		9,213	7,953	9,153	8,763	9,249	9,762	10,301	10,868
Net Sales		100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Goods Sold		74.1%	76.0%	74.0%	76.1%	76.1%	76.1%	76.1%	76.1%
Gross Profit		25.9%	24.0%	26.0%	23.9%	23.9%	23.9%	23.9%	23.9%
SG&A		4.9%	4.7%	4.8%	4.6%	4.5%	4.4%	4.3%	4.2%
Income From Operations		21.0%	19.3%	21.3%	19.2%	19.4%	19.5%	19.6%	19.7%
Depreciation & Amort.		1.5%	1.7%	1.6%	1.6%	1.6%	1.6%	1.6%	1.6%
EBITDA		22.5%	20.9%	22.9%	20.9%	21.0%	21.1%	21.2%	21.3%
Sales Growth		9.9%	-7.3%	5.3%	5.0%	5.0%	5.0%	5.0%	5.0%
Gross Profit B/4 Depreciation		27.3%	25.7%	27.6%	25.5%	25.5%	25.5%	25.5%	25.5%
Effective Income Tax Rate					39.3%	39.4%	39.4%	39.4%	39.5%
Interest Rate					5.00%	5.00%	5.00%	5.00%	5.00%

Enterprise Value via DCF Model

XYZ Company
Balance Sheet
(000's)

Dayton Acctg. Show Illustration

	Actual				Projected				
	Y/E Dec. 31				At Dec. 31:				
	Year 1	Year 2	Year 3	Pro Forma	Year 4	Year 5	Year 6	Year 7	Year 8
Balance Sheet									
Cash	$ 144	$ 866	$ 1,301	$ 1,301	$ -	$ -	$ -	$ -	$ -
Accounts Receivable	5,055	4,685	4,932	4,932	5,040	5,292	5,557	5,834	6,126
Inventory	2,998	2,848	2,919	2,919	3,150	3,308	3,473	3,647	3,829
Prepaids	300	384	443	443	210	221	232	243	255
Total	8,497	8,784	9,595	9,595	8,400	8,820	9,261	9,724	10,210
Gross Property	6,600	6,800	7,000	7,000	7,210	7,431	7,662	7,905	8,160
Accum. Depreciation	1,700	2,333	2,985	2,985	3,669	4,384	5,131	5,912	6,729
Net Property	4,900	4,468	4,015	4,015	3,541	3,046	2,531	1,993	1,431
Goodwill	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000
Total Assets	$ 15,397	$ 15,251	$ 15,610	$ 15,610	$ 13,941	$ 13,866	$ 13,792	$ 13,717	$ 13,642
Accounts Payable	$ 1,666	$ 1,582	$ 1,622	$ 1,622	$ 1,470	$ 1,544	$ 1,621	$ 1,702	$ 1,787
Accrued Liabilities	250	200	250	250	192	201	211	222	233
Current Liabilities	1,916	1,782	1,872	1,872	1,662	1,745	1,832	1,924	2,020
Short Term Debt	4,500	1,070	904	904	837	1,032	1,159	1,212	1,184
Long-Term Debt	-	3,210	2,711	2,711	2,511	3,097	3,477	3,635	3,551
Total Debt	4,500	4,280	3,615	3,615	3,348	4,129	4,636	4,847	4,735
Equity	8,981	9,189	10,123	10,123	8,931	7,993	7,323	6,946	6,887
	$ 15,397	$ 15,251	$ 15,610	$ 15,610	$ 13,941	$ 13,866	$ 13,792	$ 13,717	$ 13,642
Net Assets Employed	$ 13,337	$ 12,603	$ 12,437		$ 12,279	$ 12,122	$ 11,960	$ 11,793	$ 11,622
RONAE	276.3%	252.4%	294.4%		285.4%	305.2%	326.5%	349.4%	374.1%
Borrowing Capacity (2.0 times EBITDA plus cash less debt)	$ 14,069	$ 12,491	$ 15,991		$ 14,177	$ 14,370	$ 14,887	$ 15,755	$ 17,002

Enterprise Value via DCF Model

XYZ Company
Cash Flow
(000's)

Dayton Acctg. Show Illustration

	Projected				
	Years Ending Dec. 31:				
	Year 4	**Year 5**	**Year 6**	**Year 7**	**Year 8**
Net Income	$ 4,808	$ 5,062	$ 5,331	$ 5,623	$ 5,941
Depreciation and Amortization	684	715	747	781	817
Change in Working Capital	(316)	(337)	(354)	(371)	(390)
Capital Expenditures	(210)	(221)	(232)	(243)	(255)
Other	-	-	-	-	-
Annual Cash Flow	4,966	5,219	5,492	5,790	6,112
Beginning Cash	1,301	(0)	(0)	(0)	(0)
Dividends	(6,000)	(6,000)	(6,000)	(6,000)	(6,000)
Increase (Decrease) in Debt	(267)	781	508	210	(112)
Ending Cash Balance	$ (0)	$ (0)	$ (0)	$ (0)	$ (0)

Enterprise Value via DCF Model

XYZ Company
DCF Enterprise Value
(000's)

	Projected				
	Years Ending Dec. 31:				
	Year 4	**Year 5**	**Year 6**	**Year 7**	**Year 8**
Adjusted Cash Flows					
Annual Cash Flows	$ 4,966	$ 5,219	$ 5,492	$ 5,790	$ 6,112
Interest Expense Adjustment	90	108	127	138	139
Adjusted Annual Cash Flows	$ 5,055	$ 5,328	$ 5,620	$ 5,927	$ 6,251

Present Value of Annual Cash Flows	$ 20,074
Present Value of Residual Value	23,646
Enterprise Value of Business	**$ 43,721**

	Multiple of EV	
	Year 3	**Year 4**
EBITDA	5.0X	5.0X
NAE	3.5X	3.6X
Sales	1.1X	1.0X

EBITDA Year 8	$ 10,868
Multiple of EBITDA	3.8X
Residual Value	$ 41,673

Cost of Capital

Capital	Amount	% of Total	Pretax Cost	After Tax Cost	Weighted Cost
Debt	18,305	41.9%	5.0%	3.0%	1.3%
Equity	25,416	58.1%	30.0%	18.0%	10.5%
Total	43,721	100.0%			11.7%
			Assumed Cost of Capital		**12.0%**

Cost of Capital	Enterprise Value
11.0%	$ 46,886
12.0%	**43,721**
13.0%	40,589
14.0%	38,007

Factors to Consider to Improve EV

- **Strong management team with depth**
  - Need to encourage owners to increasingly delegate and reduce the dependence on them and build succession plans
    - Is the business highly dependent on an individual or small group?
    - Is there a succession plan for key positions?
    - Incentive plan that rewards building value?
    - Owner may want to consider “clip coupon strategy”
- **Planning process**
  - Annual business plans with budgets
    - Goals and action plans that that help improve the value of the company
  - Strategic plans that:
    - Delineates where the business stands in the market
    - Where it is going and how its going to get there
      - Marketing, Production/Operations, Technology, Human Resources
    - Basis for a confidential business memorandum

Factors to Consider to Improve EV

- **Competitive position**
  - Leader in the market or highly fragmented… buyer's want leaders
  - Entry barriers (patents, size, process, systems, distribution, etc.)
  - Low relative cost
  - Reputation and brand management in the market
- **Customer Base**
  - Do not become overly dependent on one customer - diversify
  - Longevity and loyalty of customer base
  - Reputation in the marketplace
- **Supplier Base**
  - Dependency on any particular supplier
  - Adequacy of supply

Factors to Consider to Improve EV

- **Accounting/information systems**
  - Accurate and reliable MIS systems
  - How does management use the system to drive the business
    - What are the key metrics that are used to manage the business
  - Level of outside review – audit, review, compilation
    - As you get closer to potential sale consider moving to review or audit

- **Documentation** (removes uncertainty)
  1. Keep track and document unnecessary expenses (for recasting)
  2. Corporate records up to date – minutes, by-laws, articles of incorporation
  3. Buy-sell agreements are up-to-date and with appropriate valuation method.
  4. Review of outstanding liens or potential liens
  5. Organize and review all major contracts – especially larger non-cancellable
  6. Policies and procedures manual are current
  7. Employee benefit programs – relative to market
  8. Workers' compensation – safety programs
  9. Environmental compliance – need for environmental audit
  10. Repair and maintenance (PM system)
  11. Current fixed asset ledger (possibly appraisal)

Factors to Consider to Improve EV

- **Culture of the business**
  - Is the environment encouraging where the employees have a clear sense of direction and perform at a high level?
    - Have an outside firm survey the employees
- **Housekeeping**
  - **Inventory** -- take a physical and eliminate slow moving and obsolete
  - **Accounts receivable** -- collect or write-off overdue accounts
  - Clean and organized facilities and equipment

The "How to Exit" or Realize EV
The Decision Process:

Liquidity Alternatives

- Objectives
- Alternatives

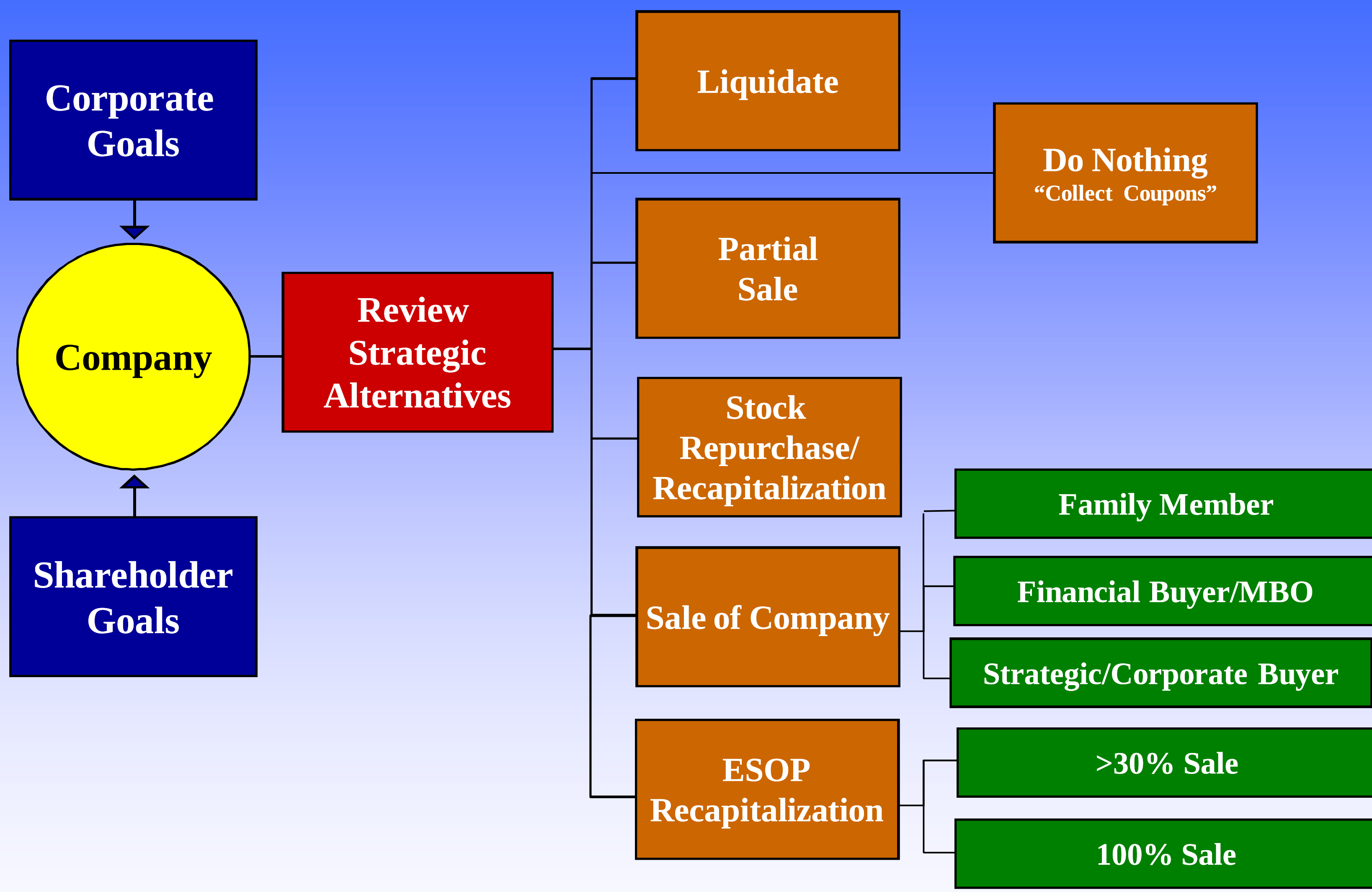
What are my objectives?

- Do I care about involving/rewarding key employees?
- Do I or don't I want to remain active?
- Do I have a succession management team?
- Do I or don't I want a continued equity interest in the company?

What are my objectives?

- How does this asset fit in my estate plan?
- How does it fit with my portfolio diversification goals?
- Do I have family in the business and/or key management to protect?

Alternatives to Realize EV



Types of Buyers

A. ***Strategic*** -- can generally pay the highest price for a business because of the potential synergies, e.g. eliminate duplicate costs, improve pricing in the market, capitalize on channels of distribution, avoid start-up costs, etc.

B. ***Financial (private equity)*** – the purchase price is based on a financial model of what they can do with the business. They need to generate a return for their equity investors and tend to capitalize on leverage (50% to 75%). They may have a vision or plan to improve the business is such a way that they can pay more than the strategic buyer. They could be a strategic buyer if they are looking for add-ons to an existing business.

C. ***Management/Employee buyout (MBO/ESOP*)** – Typically management does not have the capital to acquire business apart from partnering with a private equity firm. Thus the management or employee group will generally offer a lower price and the owner has to assume more risk and take payments over time thereby assuming more risk.

Planning for the Transition
Summary

- **Develop an Exit Planning Team** – CPA, Attorney, M&A Advisor, Financial Advisor, Insurance Advisor, Estate Planner
- **Develop an Exit Plan (written) –** financial plan, estate plan, business development, business transition, and retirement plan (retire to something)
- **Annual meeting with the Exit Planning Team –** review plan and make adjustments
- **Continue to build the value of the business –** what can we do to improve the business
- **Sell the business, transfer to family, or liquidate**
- **Enjoy retirement**

Questions

- **Any questions now?**
- **Any question later:**
  - **Jim Hollander**
  - **Tele: 937-439-4227**
  - **Email: jimhollander@cda-inc.net**

Thank You For Attending the Presentation!!