

ARNE & CO.

Business Valuations • Mergers & Acquisitions • Seminars

ROUTE TO:

VALUE ADDED™

DARRELL V. ARNE, CPA, ASA, CBA, CBI
E-Mail: Darne@Arne-Co.com
Website: www.Arne-Co.com

December, 2000

5424 Arabian Drive, NW
Albuquerque, New Mexico 87120
Telephone: (505) 898-2514 Telecopier: (505) 899-4476

Valuation and the New Economy

Some companies just aren't ready for the Capital Asset Pricing Model. Most securities analysts are trained like short order cooks to examine a company's earnings stream, apply a multiple, get an answer, and get on to the next one. Value equals earnings times a P/E ratio. Certain ranges of earnings multiples and cash flow multiples are taught as being almost universal. Just like most people like bacon and eggs, most people think six to eight times EBITDA is reasonable.

Fortunately, we now have a new crop of stocks that, despite their recent fall from grace in the market, persist in their challenge to many traditional notions of valuation. These so-called "New Economy" stocks, most of which are, in some way, related to information technology, have market capitalizations which fly in the face of traditional valuation measures.

If a securities analyst looks at an "emerging-stage" company (that's one whose operations are being moved from a two-car garage to a three-car garage), has no earnings, and only has an idea which may be useful to a particular market segment within a couple or three years, an analyst is likely to assign only a speculative value to the enterprise.

This view, however, has not stopped millions of professional and private investors from pouring billions of dollars into a group of information technology stocks that, while maybe not emerging stage, are certainly still development stage. The analyst who consults his or her valuation cookbook finds no help in justifying such lofty multiples. 1000 times revenues, 500 times book value, no multiple of earnings (no earnings), etc. But it would be wrong to simply dismiss the buying and selling of millions of investors with trillions of dollars of real money on the line.

As the saying goes "money is smart," meaning that the investing public doesn't make a habit of supporting lofty valuations without a reason. Speaking more technically, we

(Continued on Page 3, Column 3)

***These so-called
"New Economy" stocks . . .
have market capitalizations
which fly in the face
of traditional valuation
measures***

ESOP Ownership in S Corporations

Many companies have recognized the value of employee ownership in terms of employee loyalty and motivation as well as the numerous tax advantages to the business in maintaining an Employee Stock Ownership Plan ("ESOP"). An interesting development in the ESOP arena is the increasing number of S corporations establishing ESOPs and ESOP-owned C corporations converting to subchapter S enterprises.

Although the provisions of the Small Business Protection Act of 1996 enabled trusts such as an ESOP to be an S corporation shareholder, the Act included numerous provisions that presented significant barriers for S corporations to sponsor an ESOP. In 1997, however, Congress amended

(Continued on Page 2, Column 2)

IN THIS ISSUE

Valuation and
the New Economy 1

ESOP Ownership in
S Corporations 1

Darrell V. Arne Future Speaking Engagements

Buying & Selling a Business in New Mexico

12/01 Lorman Education
Albuquerque, NM

Best Strategies for Successful Small Business Transfers

12/06 AICPA/Louisiana Soc. of CPAs
Lafayette, LA

12/07 AICPA/Arizona Soc. of CPAs
Phoenix, AZ

12/11 Institute of Business Appraisers
Denver, CO

Tax Boot Camp for the M&A Professional

12/12 Institute of Business Appraisers
Denver, CO

06/19 International Business Brokers Assn.
Baltimore, MD

Maximizing the Value of the Closely Held Company

12/13 Institute of Business Appraisers
Denver, CO

01/17 Midwest Business Brokers Assn.
Des Plaines, IL

01/19 Colorado Business Brokers Assn.
Denver, CO

Business Valuation Courses & Presentations

02/03 New Mexico Bankers Assn.
Albuquerque, NM

02/08-11 American Soc. of Appraisers (BV204)
Manhattan Beach, CA

03/01-04 American Soc. of Appraisers (BV202)
Tysons Corner, VA

06/07-10 American Soc. of Appraisers (BV204)
Lisle, IL

09/20-23 American Soc. of Appraisers (BV204)
Tysons Corner, VA

10/04-07 American Soc. of Appraisers (BV202)
Orlando, FL

ESOP Ownership in S Corps

(Continued from Page 1)

the Act to correct technical flaws relating to ESOPs. Most importantly, the revisions to the Act exempt ESOPs from the unrelated business income tax (UBIT), making ESOP ownership much more appealing.

The revisions also allow S corporations to require cash distributions rather than stock distributions to departing employees to prevent potential disqualification of the subchapter S status. For example, an IRA is not a qualified S corporation owner, and an employee's placement of S corporation stock in her IRA would result in the termination of S status under the Internal Revenue Code).

The valuation of S corporation stock is fundamentally identical to the valuation of an interest in a C corporation. However, a number of valuation approaches require the tax-effecting of earnings/distributions, an adjustment that will convert S corporation operations to a C corporation equivalent basis.

For example, the market approach to valuation includes a variety of methods that compare the subject company with transactions involving similar investments, including publicly traded guideline companies. A direct comparison between an S corporation and a publicly traded C corporation, however, is impossible, as demonstrated in Table 1.

The S corp's hypothetical value based

on \$100 in pre-tax income and an after-tax valuation multiple of 6x is \$600, versus the C corporation's value of \$360. In order to allow for a meaningful comparison between an S corporation and a publicly traded C corporations, it is necessary to adjust the S corporation's income for corporate taxes. On a C corporation equivalent basis, net income in the example is \$60 (\$100 of taxable income tax-effected at an assumed tax rate of 40%), resulting in a value of \$360 for the enterprise.

A similar adjustment is necessary when comparing a C corporation's dividends with an S corporation's distributions. C corporation shareholders pay income taxes at their applicable tax rate on dividends received. The S corporation shareholder, however, is responsible for the taxes on his or her share of the company's income, whether a distribution occurred or not. As a result, it is necessary to convert distributions from an S corporation to a C corporation equivalent basis before any valuation inferences can be drawn.

This example illustrates that an S corporation's value cannot be derived simply by applying after tax valuation multiples to S corporation net income or distributions.

Similarly, there is no S corporation premium resulting simply from the conversion to a subchapter S corporation. Therefore, if there is no

Table 1

	S Corporation	C Corporation
Pretax Income	\$ 100	\$ 100
Corporate Taxes	<u>\$ 0</u>	<u>\$ 40</u>
Net Income	<u>\$ 100</u>	<u>\$ 60</u>
Valuation Multiple	<u>6 x</u>	<u>6 x</u>
Value of the Enterprise	<u>\$ 600</u>	<u>\$ 360</u>

increase in value as a result of conversion, what would explain the recent surge in conversions to S corporations?

The key incentive for ESOP ownership of an S corporation appears to be the tax-exempt status of distributions to the ESOP. The higher the ESOP's ownership stake in the company, the less taxes are paid. If the ESOP is the sole owner of the S corporation, the organization pays no income tax.

There are potential disadvantages to the S corporation ESOP. First, a

An interesting development in the ESOP arena is the increasing number of S corporations establishing ESOPs and ESOP-owned C corporations converting to subchapter S enterprises

Section 1042 "Rollover" (the deferred recognition of gain on the sale of stock to an ESOP) is not available to S corporations. Second, contribution limits for S corporations to pay ESOP debt are limited to 15% of payroll (but increases to 25% if the ESOP contains money pension purchase provisions). Third, S corporations can only have one class of stock, and any distributions must be made pro rata.

Since most S corporations distribute an amount at least equal to the shareholders' tax liability and the ESOP has no tax obligation, funds that could be available for reinvestment have to be distributed to the ESOP. However, these funds could be used for a variety of purposes, including ESOP debt retirement, additional stock

purchases, or payments to terminated employees.

C corporations with ESOPs desiring conversion to S status must also consider the following:

- S corporations must operate on a calendar year.
- The number of shareholders is limited to 75 (the ESOP counts as one shareholder, no matter how many participants).
- Subchapter S election requires the consent of all shareholders.
- Some fringe benefits paid to 2% or more owners are taxable.
- S corporations using LIFO accounting on conversion are subject to a LIFO recapture tax.
- The sale of assets is subject to a built-in gains ("BIG") tax on that sale for a period of ten years after conversion.
- Net operating losses incurred as a C corporation are suspended while an S corporation but may be applied against the LIFO recapture tax and/or the BIG tax.
- In some states, ESOPs may be subject to state unrelated business income tax.

ESOP ownership in S corporations can create advantages for employers and employees. While employee ownership provides many intangible advantages as compared to more traditional ownership structures, the ability of ESOPs to own a stake in an S Corporation may very well be one of the most financially rewarding changes in tax legislation. ♦

Valuation and the New Economy

(Continued from Page 1)

are reminded that the efficient market hypothesis generally purports that stocks are valued by the marketplace for a reason.

So what does this mean to the valuation of new economy stocks? If a stock is valued as an earnings stream times a multiple, we must delve into the rationale for both to understand the valuation of a new economy stock. It may be not only that the multiples are skewed, but that the reported financial results prepared in accordance with Generally Accepted Accounting Principles (GAAP) are also skewed.

GAAP was not designed for the New Economy. Like Rene Magritte's painting *Ceci N'est Pas Une Pomme* (This is not an apple - i.e. it's a picture of an apple), analysts have to be cognizant of the fact that audited financial statements are a representation of a company's financial results, not the results themselves.

The constructs of depreciation and amortization favor Old Economy stocks, allowing asset intensive businesses to write off the costs of bricks and mortar over their "useful lives."

A start-up manufacturing concern can spend millions on highly specialized building and equipment. If they use straight-line depreciation and an average useful life of fifteen years, only about 6% of the cost of its capital investment is deducted from earnings each year as depreciation. This asset base is supposed to provide some comfort to investors in the event of a downturn in the business. But is that reasonable?

(Continued on Page 4)

If the manufacturing concern goes out of business, its highly specialized equipment may have very little value in liquidation. And if the local economy is generally depressed, its real estate could have few buyers. Despite this, GAAP allows such a company to report a substantial asset base, and charge very little of it to quarterly and annual earnings.

New Economy stocks, on the other hand, tend to make their capital investment in systems, people, and brand-image. GAAP does not favor these sorts of investments. Although you might be able to capitalize some systems development (software and hardware infrastructure), the useful life over which it would be amortized would probably be short, say, five years, and thus 20% of the cost (on a straight line basis) would be deducted from earnings each year.

Spending on people (compensation expense) and image building (advertising) cannot be capitalized, despite the fact that their value may extend well beyond one year.

If this sounds crazy, think about Coca-Cola. We don't have access to the early financial statements of the soft drink maker, but no doubt the market value of its stock was built on a very aggressive advertising campaign. Today, their operations consist primarily of advertising and carbonated sugar water. It still takes quite a lot of advertising to maintain and refine the image of Coke, but the impact is far less than if they were trying to establish a dominant global brand identity from scratch.

Coca-Cola is not a New Economy stock, but the development of the small soft drink maker into a global brand followed the same pattern that Amazon.com or Yahoo have followed. Time will tell whether or not these New Economy stocks will have the lasting brand image of Coca-Cola; it is likely that most will not.

Fortune magazine columnist Geoffrey Colvin has noted that if Amazon.com could capitalize its investment in intangibles, it would have reported a profit of over \$400 million in 1999 ("*The Net's Hidden Profits*", April 17,

2000), versus its reported GAAP losses of -\$720 million. Colvin's recasting of earnings if calculated at Amazon.com's pricing at the time this article was written would result in a trailing P/E ratio of about 30x earnings (based on its recent trading price of \$33 per share, it has an equity market capitalization of about \$12 billion). This is not cheap, but not ridiculous for a company whose revenues are expected to grow at supernormal rates for many years.

The valuation of New Economy stocks requires some thinking outside the traditional norms of financial analysis. We still think investors buy companies for their earning power, but it's important to not be too restrictive in what constitutes earning power, or what a rational expectation for earning power might be.

Money is indeed smart, and we will continue to be open to learning from the wisdom of millions of investors, many of whom manage to consistently stay one step ahead of professional securities analysts. ♦

* * * * *

This publication is intended to provide accurate and authoritative information on the subject matter covered. It is distributed with the understanding that the publisher and distributors are not rendering legal, accounting or other professional services and assume no liability whatsoever in connection with its use.

ARNE & CO.

5424 Arabian Dr. NW

Albuquerque, NM 87120-2247