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Winter, 2000

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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 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

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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 the Act to correct technical flaws

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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? 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

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ESOP Ownership in S Corps

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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 corporation'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 above 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.

Table 1

	S Corporation	C Corporation
Pretax Income	$ 100	$ 100
Corporate Taxes	$ 0	$ 40
Net Income	$ 100	$ 60
Valuation Multiple	6 x	6 x
Value of the Enterprise	**$ 600**	**$ 360**

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 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 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. ◆

Understanding the Guideline Company Method

The art of business valuation offers significant discretion in defining the appropriate methodologies to be employed in deriving indications of value. Although discretion has been critical to the advancement of the business valuation industry, it increases the opportunity for misunderstanding and misapplication. The guideline company methodology, within the market approach, is often the victim; however, it remains a favorite of analysts because resulting indications of value are principally founded upon actual transactions of corporate stock. Reasonable application of this methodology requires an understanding of public market pricing and relative comparability. When conducted appropriately, guideline company analysis can provide a wealth of information and significant direction in determining value.

The U.S. public capital markets reprice thousands of securities every day, mostly through transactions among reasonably informed financial buyers and sellers. These transactions provide a constant flow of information reflecting agreed upon securities pricing, relative to the fundamental variables perceived to derive security value. Some of the commonly cited financial variables include cash flows, earnings, and book value. Multiples of these and other relevant financial variables are important investor valuation yardsticks.

The standard measure of equity investor returns, in accounting terms, remains net income. However, equity multiples of net income drawn from the public markets are often skewed as a result of varied capital structures. To what extent should a company's capital structure affect value? Does the capital structure affect a company's relative risk return profile? These are questions that analysts must address when employing the guideline company method. In contrast to popular belief, deriving guideline-based indications of value is not as simple as price times earnings equals value.

Imagine two companies that differ only in terms of their specific capital structures (see Table 1). One employs significant financial leverage and the other is relatively debt-free. The leveraged company, as a result of interest expense, will report lower net income relative to the debt-free company. Should these two companies have the same value? Should interest expense and operating expenses have the same valuation implications?

Sometimes it is desirable to address the value of the company's entire invested capital (common equity, preferred equity, and interest bearing debt). Using guideline company multiples to value a company's invested capital and then subtracting the value of interest bearing debt is useful for

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Table 1

	Market Value of Equity	Market Value of Debt	Earnings	EBITDA	P/E	Total Capital to EBITDA
Guideline Company A	$1,000	$2,000	$100	$300	10	10
Guideline Company B	$1,000	$200	$100	$200	10	6
Subject Company 1	*See Below*	$2,000	$100	$300		
Subject Company 2	*See Below*	$200	$100	$200		

VALUATION ANALYSIS

Subject Company 1

Using Guideline Co. A
MVE (P/E) = 10 (P/E) x $100 (Earnings) = $1,000
MVE (EBITDA) = [10 (P/EBITDA) x $300 (EBITDA)] - [$2000 (Debt)] = $1,000

Using Guideline Co. B
MVE (P/E) = 10 (P/E) x $100 (Earnings) = $1,000
MVE (EBITDA) = [6 (P/EBITDA) x $300 (EBITDA)] - [$2000 (Debt)] = -$200

Subject Company 2

Using Guideline Co. A
MVE (P/E) = 10 (P/E) x $100 (Earnings) = $1,000
MVE (EBITDA) = [10 (P/EBITDA) x $200 (EBITDA)] - [$200 (Debt)] = $1,800

Using Guideline Co. B
MVE (P/E) = 10 (P/E) x $100 (Earnings) = $1,000
MVE (EBITDA) = [6 (P/EBITDA) x $200 (EBITDA)] - [$200 (Debt)] = $1,000

valuing minority equity interests where guideline company and subject company capital structures differ significantly.

An analyst, by carelessly reviewing guideline company price to earnings ratios, might deduce that the market is pricing a leveraged company at a significant relative premium to a debt-free company. In some cases this deduction might be valid. If the leveraged company is generating higher returns and not compromising financial stability, then premium relative pricing is likely deserved. However, it is more likely that the market recognizes the influence of the capital structure and has determined relative pricing based upon debt-free earnings measures higher up the income statement. Lack of thorough market analysis can lead to unreasonable valuation conclusions.

Multiples of EBIT (earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation, and amortization) are often analyzed when applying the guideline company method. Both measures represent earnings available to both equity and debt holders, and therefore are not directly influenced by capital structure.

The bottom line is that relative capital structures can affect valuation. Analysts need to be aware of this fact. The example in Table 1 could have presented guideline companies with similar total capital multiples and different P/E multiples, in either case, the potential effect on value is apparent. ◆

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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 current pricing 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. ◆

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