



Isis Rental Management Company Case Study

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Isis Rental Management Company was founded thirty-five years ago by Tom and Eva Williams to provide long-term rental management services to owners of apartments, condominiums, townhomes, office buildings, retail space, etc. Since its founding, Isis Rental Management Company has maintained a fairly stable staff as a result of the pleasant working environment created by the Williams family. The benefits offered to loyal employees are also very good and the family-like feel of the organization has been maintained despite its rapid growth from a small, family business with \$250,000 in revenues to a sizeable, regional rental management company with over \$8 million in annual revenues. With the exception of several seasonal employees, the staff has an average tenure of over twenty years. Several employees have been with the firm since its inception. Even the newest employees have been with the firm for ten years or longer.

At 60, Tom and Eva are quickly approaching retirement age and seeking personal liquidity through either a sale of the company or a recapitalization. Both agree that they no longer want to participate in the management of the business, as they are looking forward to enjoying retirement after many years of hard work. Their three children all have lucrative careers and have no interest in the business. Their grandchildren are too young to work the business, and Tom and Eva do not want to keep running the firm until the grandchildren have graduated high school and college. Therefore, they are actively seeking a transaction to exit the business.

As they have already made the decision to sell Isis Rental Management Company, Tom and Eva retain an established, highly-regarded investment bank to assist in selling the company. Several local, regional, and national rental management companies express an interest in merging with or acquiring Isis Rental Management Company. The indications from the various suitors are favorable with respect to price. The lowest offer is roughly \$6 million with the highest offer being \$11 million. Though several of the potential buyers drop out of the process, three companies remain interested and are likely to engage in a bidding war. The investment banker assures

the Williams that this is the best way to maximize value in the negotiations. The investment banker believes that the business will ultimately be sold for something in excess of \$11 million.

The Williams are excited about the prospects of closing such a lucrative deal that values Isis Rental Management Company at 50% more than the fair market value estimate prepared by the investment bank's in-house financial analysts. At one of the site visits, however, Tom and Eva are disturbed to learn that one of the bidders is likely to lay off most of the staff in the event they acquire the business and consolidate Isis' operations with their headquarters over fifty miles away. At the other site visits, the remaining suitors also inform them that they intend to cut the staff numbers dramatically. Tom and Eva become more concerned by this, as they had hoped that any acquirer would maintain the current operations and take care of the staff that had been so loyal to them and so instrumental in helping the company grow over the years. After discussing this issue with the investment banker, Tom and Eva are wary of proceeding with a sale of the company.

Seeing that they are uncomfortable with the situation, the investment banker proposes that they consider selling Isis Rental Management Company to an Employee Stock Ownership Plan. Setting up an ESOP would enable the workers to enjoy the benefits of ownership of the firm while preserving the identity of the organization. Though they may not be able to secure as high a price through a sale to the ESOP, they would have the satisfaction of knowing that the employees would have job security and have the opportunity to gain financially through their continued participation in the firm. Both Tom and Eva are very enthusiastic about this proposal and are willing to sacrifice part of the purchase price to help their employees increase the likelihood that they stay employed and gain ownership of the firm.

In order to initiate the ESOP formation process, Isis Rental Management Company engages an independent business valuation firm to conduct a fair market value appraisal. In preparation of the valuation, the analyst learns that Tom and Eva have run an efficient business operation, expensing only legitimate business expenses and not including any of their personal expenses in the financials of the firm. In addition, their salaries have been comparable to other executives in the industry. The limited amount of debt on the balance sheet, \$250,000, is attributed strictly to the business. As a result, the valuation analyst does not make any significant adjustments to the financial statements of Isis Rental Management Company.

The valuation analyst decides that it is appropriate to use a single period capitalization method under the income approach and the direct market data method under the market approach. The firm's net income before taxes is roughly \$2 million with net cash flow to invested capital of roughly \$1.3 million. The valuation analyst estimates the cost of equity capital at roughly 21% using a build-up method. Given the low amount of debt in the capital structure of the firm relative to the \$5 million equity on the balance sheet, the weighted average cost of capital is estimated at 20%. With a long-term sustainable growth rate of 3%, the capitalization rate applicable to the net

cash flow to equity is 17%, which produces a capitalization multiple of 5.88. This results in a valuation estimate of \$7.6 million. Removing the long-term debt of \$250,000 from this value indication produces a value estimate of the firm's equity of \$7.35 million. After conducting a factor analysis and applying reasoned, informed judgment, the valuation analyst concludes that a 15% discount for lack of marketability is warranted. Therefore, the fair market value estimate under the single period capitalization method is roughly \$6.25 million on an enterprise basis.

The valuation analyst also believes that the direct market data method under the market approach is appropriate for estimating the fair market value of the firm. A search of the various transaction databases yields over three hundred transactions in the rental management industry. The average price to sales ratio is 1.2 with a median of 1.1 and a standard deviation of 0.12. Given the risk profile of the firm and financial characteristics specific to it, the valuation analyst elects to apply a price to sales multiple of 1.15 to the revenues of Isis Rental Management. Based on \$8 million in annual revenues, this produces an indication of value of \$9.2 million. Adjusting for differences in working capital (cash + accounts receivable – accounts payable), the fair market value indication is \$9 million on an enterprise basis. With the removal of the \$250,000 in long-term debt, the fair market value estimate of the firm's equity is \$8.75 million

Weighting each method equally, the valuation analyst concludes a reconciled fair market value estimate of the firm's equity of \$7.5 million or \$15.00 per share based on 500,000 shares issued and outstanding. Though this is substantially below the potential price that Tom and Eva could likely realize through a sale of Isis Rental Management, they remain content to sell the firm to the ESOP for the fair market value estimate as developed by the valuation analyst. The Williams' advisors conduct a feasibility analysis to assess the likelihood that the ESOP will be able to service the debt associated with the leveraged buyout. Confident that the cash flow of the firm is ample to meet the debt obligations, the Williams and their advisors proceed with the sale of the firm to the ESOP.

Upon completion of the transaction on January 1st, Tom and Eva receive \$6.75 million (from which they must pay their advisors and their taxes). In addition, they have both agreed to remain as members of the executive management for two years while the transition to the new leadership occurs. This employment contract carries with it a fee of \$200,000 per year for Tom and \$100,000 per year for Eva; these salaries are slightly lower than that which they have been taking over the last few years. At the end of two years, Tom and Eva have agreed to assume a consulting role for three additional years. This consulting contract has an earnout worth an additional \$2.5 million if the firm meets its performance targets over the next five years. This enables Tom and Eva to achieve a great deal of liquidity, maintain an active role in the management of the company during the transition period, and still benefit from the firm meeting performance targets.

At the end of the first fiscal year of ESOP ownership, Isis Rental Management Company once again retains the valuation analyst to conduct the annual valuation of

the firm for regulatory compliance and reporting requirements. The forecast that had been prepared jointly by the analyst and the executive management for Isis Rental Management Company as part of the initial valuation a year ago was an accurate indicator of the actual performance in the first year under ESOP ownership. Net cash flow to invested capital increased slightly to roughly \$1.34 million on revenues of \$8.5 million.

The valuation analyst estimates the cost of equity capital at 23% using a build-up method, slightly higher than in the initial valuation given the increased risk associated with the higher level of debt. Given the increased debt in the capital structure of the firm relative to the equity on the balance sheet, the weighted average cost of capital is now estimated at 15%. With a long-term sustainable growth rate of 3%, the capitalization rate applicable to the net cash flow to equity is 12%, which produces a capitalization multiple of 8.33. This results in a valuation estimate of \$11.2 million. Removing the long-term debt of \$6.75 million produces a value indication of the firm's equity of \$4,450,000.

Though the applicability of a discount for lack of marketability is a debated issue amongst the valuation profession, given that shareholders have a right to "put" their shares back to the ESOP upon leaving the company, the analyst believes that these shares are still relatively less marketable to investors than shares in publicly-traded companies that are freely traded on an exchange and that possess a much higher degree of liquidity. After conducting a factor analysis and applying reasoned, informed judgment, the valuation analyst concludes that a 10% discount for lack of marketability is warranted, lower than the discount may have been in the absence of the ability to put shares back to the ESOP. Therefore, the fair market value estimate of the firm's equity under the single period capitalization method is roughly \$4 million.

The valuation analyst also believes that the direct market data method under the market approach is once again appropriate for estimating the fair market value of the firm. Another search of the various transaction databases yields the same three hundred transactions in the rental management industry that were used in the initial valuation. The average price to sales ratio is 1.20 with a median of 1.10 and a standard deviation of 0.12. The valuation analyst elects to apply a price to sales multiple of 1.15 to the revenues of Isis Rental Management once again. Based on \$8.5 million in annual revenues, this produces an indication of value of \$9.775 million. Adjusting for differences in working capital (cash + accounts receivable – accounts payable), the fair market value indication is \$9.5 million on an enterprise basis. Removing the long-term debt from this produces a value indication of the firm's equity of \$2.75 million.

Weighting each method equally, the valuation analyst concludes a reconciled fair market value estimate of \$3.375 million on an enterprise basis or \$6.75 per share based on 500,000 shares issued and outstanding. This is substantially below the valuation conclusion arrived in the initial valuation report due to the increased debt levels in the capital structure. As the debt is gradually paid off and the firm's net cash flow to

invested capital and revenues continue to increase, the per share value of the firm will converge with the value arrived under the initial valuation, *ceteris paribus*.

The preceding is a very simple example that illustrates the role of a valuation analyst in the process of a leveraged buyout of a closely held business as part of an ESOP. There are, of course, other factors that the analyst must consider in conducting the valuation, such as the ability of the ESOP to repurchase shares also known as the repurchase obligation. Full details and discussion are beyond the scope of this case study. However, this example also illustrates a potential exit strategy for owners of closely held businesses who seek personal liquidity while ensuring the future of the firm lies in the hands of those who helped to make the company strong over the years. A leveraged buyout with an ESOP may be the optimal solution under those circumstances.