

Stress Testing the Closely-Held Company

How will capital markets and the economy affect shareholder risk and return in the companies that drive 52% of the U.S. economy and how can owners measure the health of their company?

By: William H. McAfee, Jr., CFP®, AVA

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Developers of:



Executive Summary

Large financial companies are being required to undergo “stress testing” to determine how they will perform in various economic situations. For companies with less than 500 employees, there is no requirement to perform stress testing, but it may be crucial given the limited availability of capital and the decrease in consumer spending. Most small companies do not have the cash reserves to weather the storm like the large publicly-traded ones. Small companies should be asking, “Will we be able to grow the value of our company in this environment,” and “How much capital will we need to sustain the company whether sales go up or down over the next few months?” Ultimately, owners of small companies will ask, “Am I getting compensated well enough for taking this risk?” While stock markets are already indicating that the risks are diminishing, the effect of the recession may just be setting in for the smaller company.

Introduction

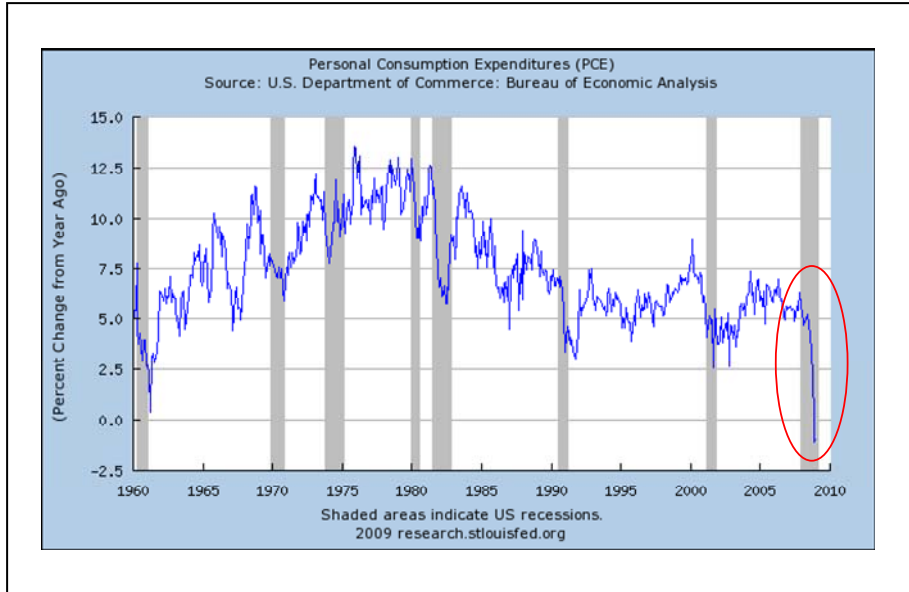
Recently there has been increased media attention on the “stress testing” of banks and financial companies to determine the health of their capital pool, and whether or not they will be able to weather a prolonged financial crisis or other shock to the capital markets. Many individuals will understand the term “stress test” as it relates to a medical check-up. In that setting the term asks the question, “What is the risk of a heart attack?” In stress testing a company, the real question can be expressed as, “What is the risk of a business heart attack?”

In particular, the business should ask 3 specific questions when conducting a stress test:

- 1) How much economic and financial stress can the company withstand?
- 2) How much can the company afford to grow before it is unhealthy?
- 3) How much does the stress affect the value of the company share price over time?

Economic Background

The U.S. and world economies suffered a major shock over the 24 month period beginning in the 4th quarter 2007. Banks had aggressively loaned money for real estate development in periods leading up to that point and as real estate markets became saturated with supply, real estate prices began to fall. In addition, the quality of loans made to purchasers of homes was found to be increasingly poor and the secondary market for mortgage-backed securities dried up causing additional pressure on the housing market and home prices. Consumers reacted by sharply curtailing spending as they could no longer access home equity for increased purchasing. In fact, consumers bought significantly fewer goods and services than at any point since The Bureau of Labor Statistics started measuring consumer demand.



Businesses found that they suddenly had two compounding problems; consumers weren't spending and banks weren't lending. The survival of many companies was suddenly at risk when just a few months prior, many companies had record years in both revenue and profits.

Figure 1

The sharpness of the recessionary downturn dramatically affected stock markets and investors pulled significant sums out of public company investments. Ironically, large companies in the U.S. that comprise the Standard & Poor's 500 Index were relatively prepared to weather the storms of this economic environment. On average, these companies had 9% of their assets in cash accounts as of December 31, 2008 with the largest balances at over \$60 Billion (See Figure 2). Comparatively, companies having fewer than 500 employees (representing 51% of the U.S. Gross Domestic Product) don't have this cash storehouse. So in order to grow and survive, the small company must get access to credit from banks as well as reinvest profits when possible.

Many small companies may be tempted to simply wait for the turnaround in housing and consumer spending as a survival strategy. However, this turnaround is likely to take longer than most businesses can withstand. With the current and anticipated constraints on financial institutions, it is unlikely that aggressive practices which led to the peak in housing and consumer spending in 2006 will resume at any

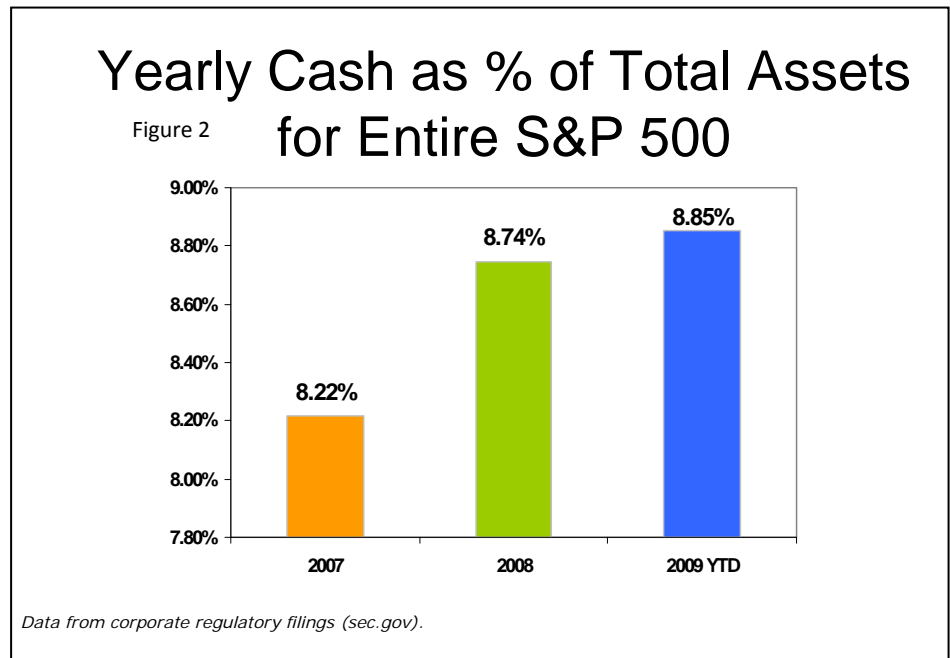


Figure 2

foreseeable point in the future.

In fact, the use of debt in the U.S. has grown faster than the overall growth of the U.S. economy since the mid-1980's (See Figure 3). This became an issue as business and consumers over-borrowed and banks became over-levered, putting more cash into loans and continually lowering reserves to an average of less than 1% of outstanding loans. This increase in leverage, outstripping economic growth, led to the significant increase in volatility we've seen in stock markets over the last 20 years. The leverage has quickly unwound in the last 6 months and banks are now increasing reserves back to historical norms. Because of the effect of this de-levering, businesses and consumers will have to get used to a "new normal". De-leveraging is healthy, as it reduces financial risks and is an ingredient in the recovery, but it may also curb business growth for companies in need of debt capital to fund this growth.

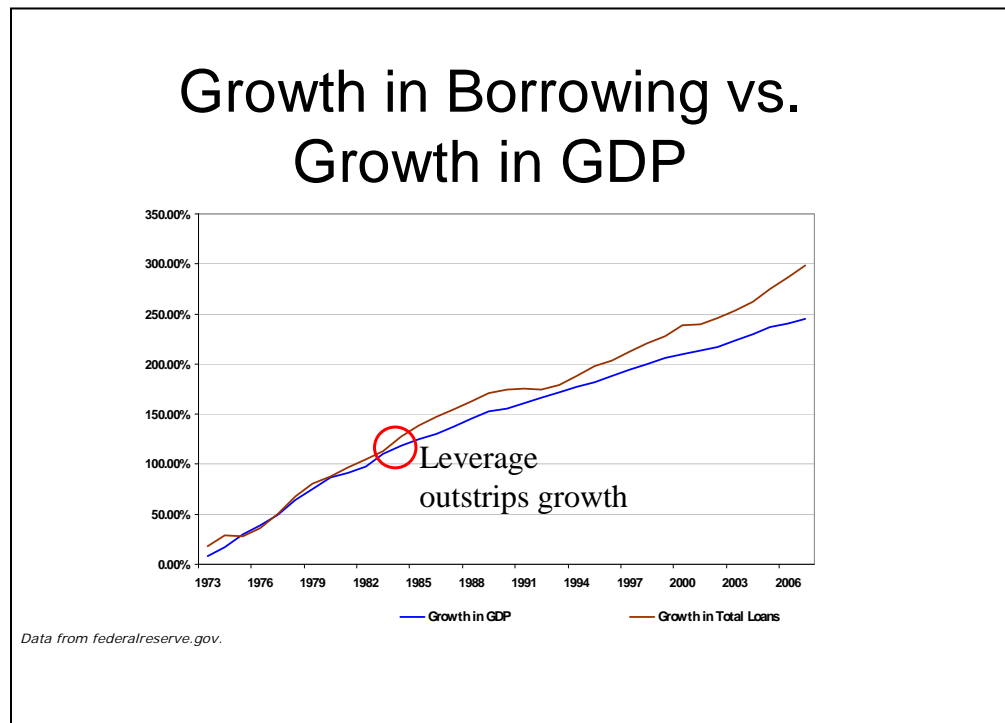


Figure 3

Because of the current condition of the capital markets and projected environment of reduced economic growth over the next 2-3 years, small company shareholders need to examine their companies on a number of key financial areas. They should determine whether they will be adequately compensated in terms of share price for the risks they are taking and determine what strategic options may be available.

Understanding private company stock prices

The metrics for determining the stock price of any company are best portrayed in the formula:

$$\text{Stock Price} = \frac{\text{Financial benefits received by shareholders}}{\text{Risk to shareholders of the future benefits}}$$

The value of a company can grow by either increasing the benefits to the shareholders, or reducing risks to the shareholders. Most small companies focus primarily on increasing the benefit stream. However, a singular focus on increasing financial benefit stream is shown to actually increase the risk to shareholders and can have a negative effect on stock price.

Practical Strategic Implications

There are some key issues in the current environment that will drive the need for continual stress testing over the coming decade. With the lack of capital in most small companies to fund growth, and a lack of debt capital from bank funding for the foreseeable future, small companies will be pressed to make key decisions on growth, distribution and exit strategies.

Given the importance of access to capital, the current environment is detrimental to owners of companies who do not have significant cash reserves. Even for those who do have the ability to fund the company from the shareholder wallet, the question still looms, "Should you?"

M&A opportunities

One key issue that will provide some level of opportunity is the level of cash on large corporate balance sheets. In the coming slow growth environment, these large public entities will feel some level of pressure to grow earnings. If organic growth is not available, these companies will look for ways to deploy their cash assets in M&A activity. Small companies who have niche markets or products, or who represent an investment with predictable return and economies of scale opportunities will be in demand.

Shareholders in these small companies will need to determine their current share price, without relying on average industry multiples. The transactional risk of "leaving money on the table" is a potential issue for those who rely solely on these multiples for valuation.

Also key for shareholders will be quantifying their financial objectives. Questions such as, "When is the stock price at the top," will need to be examined in line with "What do I need the stock price to be in order to achieve my lifestyle goals?" Stress testing the company can give an indication not only of the stock price maximization, but also provide scenario analysis on the delay of an exit in the face of an M&A opportunity and the potential for additional stock price appreciation given the capital availability in the current company.

Family Business Transactions

Again, with the diminished ability to find funding, family businesses looking for generational transfer will have significant challenges. Will the business survive if the senior generation leaves with a trailing cash flow demand? How should the transition be structured given the constraints of the stress tested scenarios?

Understanding the growth capability of the company for the junior generation can be measured using a stress testing approach and can give a clear indication of return on investment for the junior generation.

If the family company will be unable to fund the future growth, then the stress test can indicate the appropriate structure in light of the family objectives.

Investment Decisions

When shareholders receive income that isn't being reinvested, there is little thought on how the distribution will affect share price. In addition, there is no clear understanding for many shareholders on how to properly diversify by investing distributions into other investments that may offset the risk inherent in the small company.

Stress testing can provide insight into the appropriate levels of distributions as well as insight into the appropriate types of investments to diversify risk in light of the small company stock ownership.

Conclusion

Stress testing is required for large financial companies. Given the state of the global economy and capital markets, it is advantageous for small companies to undertake the same stress testing. In fact, because of the complexities involved in most smaller companies, a regimen of stress testing can not only indicate problem areas in advance, but can be a useful management tool in optimizing the stock price over time. The measurement of stock price and stress test factors can also provide business intelligence in preparation for strategic decisions that all businesses eventually face.

Why Stress Test?

- 1) Track business value and risk.
- 2) Indicate how well a company is positioned to withstand capital market risks.
- 3) Understand what level of sales growth is healthy.
- 4) Will the company meet the shareholder exit objectives.

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