

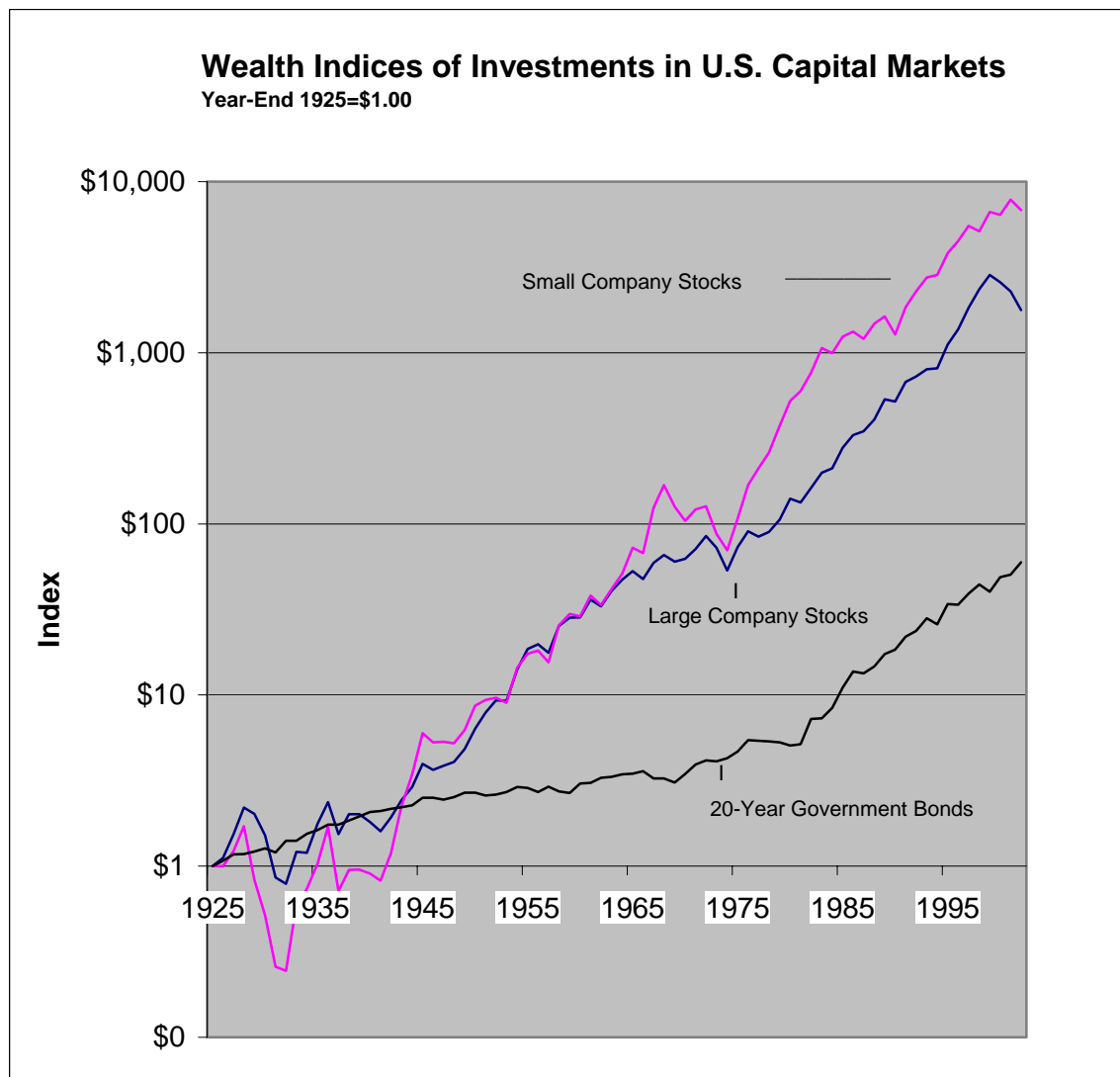
## **Remaining Public – The Best Option in Troubled Markets?**

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### *Introduction*

Recently, some finance professionals have advocated that many smaller-capitalized companies with little investor attention, referred to as “orphans”, go private. Since the Sarbanes-Oxley Act became law in July 2002, more companies have, at least, analyzed the decision to go private given the stringent requirements and increased costs of being a public company. Before a company explores privatization, however, it would be remiss to ignore the public stock market’s impressive long-term total return.

To say the least, the public markets have not been a bad place for companies to be. The chart below illustrates the total returns on various investments from 1926 through 2002<sup>1</sup>.



<sup>1</sup> Source: Stocks, Bonds, Bills, and Inflation: Valuation Edition 2003 Yearbook.

The chart shows that one dollar invested in small company stocks<sup>2</sup> at the beginning of 1926 grew to \$6,816.41, on a total return basis, by the end of 2002. By contrast, one dollar invested in large company stocks<sup>3</sup> grew to \$1,775.34, or \$5,041.07 less, over the same period. Finally, one dollar invested in 20-year government bonds, a risk-free investment, grew to only \$59.70 by the end of 2002. Thus, investors who purchased equities, especially those investors who purchased small company stocks, on average, were handsomely rewarded for their assumed risk.

As we are all aware and as shown on the chart above, the stock market does not increase every year. In fact, the stock market's return has been negative the last three years. In 2000, 2001, and 2002, the S&P 500 returned -10.1%, -13.0%, and -23.4%, respectively<sup>4</sup>. The year-to-date return through June 25, 2003 was +10.9%.

Over time, the stock market may correct temporary inefficiencies in pricing – especially if a company is making a concerted effort to inform and educate the investing public. Therefore, history and the returns to date in 2003 illustrate that it may be shortsighted to base one's decision to go private on investor returns of only a few years. Companies would also do well to remember some of the reasons they went public in the first place.

#### *Advantages of Being Public*

The public markets offer many advantages that are unavailable to privately held companies, including:

- (1) Increased access to capital – both debt and equity;
- (2) The ability to acquire or merge with other companies more easily;
- (3) More media attention;
- (4) An enhanced image;
- (5) Improved liquidity; and
- (6) The ability to attract better employee talent through stock option benefits and other forms of compensation.

These advantages may be more pronounced if the particular company is not an “orphan”. Nonetheless, they remain advantages.

#### *Sarbanes-Oxley Act*

In the short-term, this law has created new burdens for public companies. The law requires officers to certify their financial statements and holds them criminally accountable for errors or omissions. The law also sets new requirements for the

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<sup>2</sup> Performance of the fifth capitalization quintile of stocks on the NYSE for 1926-1981, performance of the Dimensional Fund Advisors (DFA) Small Company Fund for 1982-March 2001, and performance of DFA Micro Cap Fund for April 2001-December 2002.

<sup>3</sup> Performance of the S&P 90 for 1926-1956, and performance of the S&P 500 for 1957 – 2002.

<sup>4</sup> Source: S&P 500 prices obtained from Yahoo!Finance.

independence and qualification of the board of directors. In response, companies are paying more in legal, insurance, executive search, and audit fees. A recent survey by Foley & Lardner, a law firm, determined the annual cost of being public has nearly doubled from \$1.4 million to \$2.3 million. Thus, there is little debate that the requirements to be public have become more onerous and, therefore, costly – in the short-term.

If one takes a longer-term perspective, however, the initiatives called for by the Sarbanes-Oxley Act should reap many benefits for public companies. The primary objective of the Act is to restore investor confidence. If the Act accomplishes its goal, then investors will once again trust that public companies are being ethically and effectively governed to maximize shareholder returns. Once trust is restored, it is likely that public companies' cost of capital will decrease and more than outweigh the approximate \$1 million annual cost to abide by the Act. Thus, even “orphan” companies should take a long-term perspective and carefully weigh the benefits and costs of compliance with the Sarbanes-Oxley Act.

### *“Orphan” Companies*

Some finance professionals claim an “orphan” company exhibits some, or all, of the following characteristics<sup>5</sup>:

- (1) A market capitalization of \$250 million or less;
- (2) A book value that substantially exceeds market capitalization;
- (3) Fewer than two financial analysts covering the company and issuing regular research reports on it;
- (4) A price-earnings ratio of less than 10;
- (5) Cash on hand greater than market capitalization; and
- (6) Average trading volume of less than 50,000 shares a day.

### *Reasons for “Orphan” Status*

The symptoms exhibited by an “orphan” are due to one of two sources. First, a company may be an “orphan” because an inefficient stock market does not recognize the company's inherent value. Conversely, an efficient market may bestow “orphan” status on a company and properly value the company as the company has no viable business plan and limited, if any, growth prospects. Either way, “orphans” do not enjoy the many benefits of being public.

“Orphans” should, at least, *consider* going private. Let's look more closely at the details, the process, and the ultimate decision to go private – while remembering the historical long-term returns of the stock market.

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<sup>5</sup> Range, Gregory, “Going Private – A No-Stigma Way to Shield the Orphan Image,” *ACG Network*, February 2003.

### *Strategies to Create Investor Attention*

While not dismissing the benefits of going private for some companies, most companies should pursue other strategies first before giving up on the public markets. If the company's stock is trading in an inefficient market, the company can undertake certain actions to create more investor attention. Under this scenario, five of the "orphan" criteria really stem from the sixth – the fact that the company has little, if any, analyst coverage or investor attention. This may be corrected relatively easily and inexpensively:

- (1) The company could hire an independent research firm to issue reports;
- (2) The company could engage a public relations or an investor relations firm to get the word out; and/or
- (3) The company may issue press releases, or other "buzz" to create attention.

In summary, if the story is worth telling, then tell it and tell it well. By undertaking such actions, the stock market has a better chance, over time, of recognizing the company's inherent value.

### *Costs to Go Private*

If a company fails to create investor attention, and then wishes to go private it should still consider the items below. First, the premium required to entice shareholders to accept the buy-out may be substantial. In 2002, according to Mergerstat, the average and median premiums for control equaled 59.7% and 34.4%, respectively. Management better have significant value-added strategies as a private company, over and above what they would be able to execute as a public company, to pay control premiums in this range.

Many companies may find it hard to raise the capital to pay off the shareholders. Some reverse-IPO companies have subsequently went bankrupt due to the financial distress and excessive leverage created in a private buy-out. For example, Maxxim Medical filed for bankruptcy in February 2003 due to the debt it acquired to go private more than three years earlier in an \$800 million deal.

Most companies go private because they are struggling in the marketplace. When most companies privatize, they take on more debt – often times, significantly more debt. It is difficult to believe that this is a recipe for success. In difficult times, it is generally more beneficial to solidify the balance sheet, rather making it more precarious. As the economy improves, a company with strong financials would be more likely to pursue growth strategies without the burden of meeting high interest payments. In summary, the capital employed to go private may be more expensive than the cost of capital as a public company.

The hypothetical scenario below illustrates a typical leveraged buy-out, and then compares the result with remaining public:

Going Private

Total publicly traded stock value	\$100,000,000
Control premium to take private	30%
Transaction price (Controlling interest)	\$130,000,000
Transaction fees (10%)	<u>\$13,000,000</u>
Total amount financed	\$143,000,000

Leverage required (50%)	\$71,500,000
Annual Interest fees (10%)	\$7,150,000

Remaining Public

Annual cost to remain public	\$2,400,000
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Difference

Annual interest fees (10%)	\$7,150,000
Annual cost to remain public	<u>\$2,400,000</u>
Additional annual costs to go private	\$4,750,000
<b>Plus: \$71,500,000 in debt</b>	

Under the rudimentary example above, the annual cost to go private is \$4.75 million more than the costs to just remain public. Importantly, the \$71.5 million debt will come due eventually. In the meantime, the additional leverage used to buy-out the public shareholders will have an adverse effect on the private company's ability to pursue growth opportunities. Thus depending on the characteristics of the transaction, it is highly likely that the costs to go private will outweigh the costs to remain public.

*Costs to Become Public Again*

If a company wishes to go private only to ultimately become public again, it should consider the significant costs to go public - costs that the firm has already incurred once. The most significant cost is the underwriter commission, which generally costs about 7% of the offering size but can cost significantly more, on a percentage basis, depending on the size of the offering. Then, of course, there are legal fees, accounting and auditing fees, printing fees, SEC and state registration fees, listing fees or quotation fees, and company expenses for travel and road show requirements. Total fees may reach 9% - 20% of the offering. Thus, the total cost of capital to round-trip back to the public markets may be much more expensive than just remaining a public company.

Another item to consider is the potential legal ramification of going private if management or directors are part of the deal. If the privatization is successful, meaning the company is able to improve its operations as a private company due in large part to eliminating some of the costly burdens of being public, and the company round-trips back

to the public markets, prior shareholders may be upset that they sold out early. It is feasible that management and directors knew inside information that they did not disclose to the other investors when going private. This conflict of interest may open the company up to litigation.

### *Going Private – Not a Viable Alternative in Some Instances*

The other side of the story may be that the stock market has the story correct. In other words, the company may have no viable business plan and little, if any, value beyond its marketable securities. If this is the case, going private is unlikely to unleash any more value. Many well-established and successful private equity firms have not stepped-in to purchase these “orphans”, even though at first glance, the prices may appear compelling. The buy-out firms’ inaction corroborates the investment community’s value of many of these “orphan” companies. Under this scenario, the company should, in all likelihood, consider other alternatives to maximize shareholder value. These strategies could be liquidation or selling the business to a strategic buyer.

### *Generally, A Public Listing is Worth Fighting For*

In conclusion, while each company and situation is unique, companies should not dismiss the many benefits of being public – especially if the stock market does not have the story correct. Going private and remaining private or going private and round-tripping back to the public market may, in the long-run, be more expensive than remaining public in the first place. An inefficient market may be corrected, relatively inexpensively, by creating more investor attention or by waiting for the market to realize the value of your company. If the stock market is efficient and has valued your company correctly, then other strategies may maximize shareholder value rather than going private.

For the many advantages cited above, companies historically have sought to become public. If your public listing is worth fighting for, tell your story and tell it well, and do not be too quick to abandon the “dream” of being public.

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