



JNC Shipping Corporation Case Study

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JNC Shipping Corporation is a multinational shipping firm that operates oil tankers in the North Sea, from Venezuela to the United States, and LNG tankers in the Pacific. The executive management team is comprised primarily of members of the Cloninger family. In addition, the Board is controlled by members of the Cloninger family who share the same views on how the Company should be managed. Though there are a few independent directors, they are closely aligned with the controlling members of the Cloninger family and support the executive management of the Company. The Board asks few questions of the executive management team which has delivered steady earnings growth over the last several years. As a result, several members of the executive management team along with members of the Board have been allowing their personal expenses and those of a few “select” shareholders to be paid by the Company. This practice has become rife in the last several years, serving to depress the full earnings potential of the Company. The personal expenses associated with the executive management and the Board of Directors totaled \$1,010,000 for the most recent fiscal year and included the following items:

- CEO’s personal country club membership dues and monthly food and beverage expenses at the country club—\$122,000
- Use of corporate jet for personal travel by a Board member and family member to and from the corporate retreat in St Moritz—\$95,000
- Vacations and travel expenses of executive management following various conventions in Las Vegas, New York, Tokyo, and Amsterdam—\$35,000
- Renovations to personal residences and second homes of the CEO, CFO, and Chairman of the Board, including installation of new swimming pools, a tennis court, and fitness facilities—\$325,000

- Gifts that include purchases of artwork and jewels for friends and family members of various Board members—\$222,000
- Contributions to various charities and foundations associated with certain family members and directors—\$211,000.

In addition to the above personal expenses, the Company has made loans on favorable terms (virtually zero interest loans with no repayment schedule) to Board members, family members, and entities or businesses associated with these individuals. These loans, which are unlikely to ever be repaid, have historically been forgiven or written off by the Company. To avoid arousing suspicion and jealousy among the shareholders, these loans have been made to holding companies or other entities to protect the identity of the family member or executive who received the proceeds from the loan. As of the end of the most recent fiscal year, the outstanding loans to family members, Board members, and managers totaled \$10 million.

Beyond the annual report provided to the shareholding members of the Cloninger family, the executive management and the Board of Directors do not provide any additional information and hold no periodic family meetings to discuss the administration of the Company, the strategic plan that is reviewed periodically by the Board and the executive management, or the succession plan. With certain members of the executive management team nearing retirement age, several members of the younger generation have begun to press for a clear succession plan to be developed. In addition, JNC Shipping Corporation has been approached by several publicly traded companies and private equity groups regarding a potential merger or acquisition of the Company.

With this in mind, several younger shareholders have informally begun to press the Board of Directors to consider the available options and put them on the table. In anticipation of a potential sale and to assess the informal offers that have been made, the Board of Directors hired XYZ Financial Consulting Group to conduct a valuation of the Company. However, XYZ Financial Consulting Group is, unbeknownst to Triumvirate shareholders, majority owned (but not operated) by one of the allegedly “independent” directors serving on the Company’s Board. XYZ Financial Consulting Group mainly provides brokerage services and portfolio management services for high net worth individuals and businesses. No one at XYZ Financial Consulting Group has ever conducted a valuation of a closely held or family controlled business. The analyst selected to conduct the valuation did serve as an analyst (as an intern in college over twenty years ago) at a major investment bank where the duties involved research and analysis of publicly traded companies in the manufacturing industry.

In conducting the valuation of JNC Shipping Corporation, XYZ’s financial analyst is confronted with the following issues:

- Fearing that the other shareholders will become hostile and seek legal action, the executive management and Board chooses not to fully disclose the practice of allowing the Company to pay for certain personal expenses of

select shareholder and managers. Though the executive management and the Board know that this will artificially depress the value of the Company, they fear that the potential damage arising from revelation of their questionable activities would hinder a potential merger or acquisition. In a compromise between the executive management and the Board, they agree to provide the financial analyst with some adjustments relating to minor personal expenses which are unlikely to arouse suspicions among the other shareholders. These personal expenses total \$10,000.

- In an attempt to increase the value of the firm, the financial analyst is influenced to minimize the Specific Company Risk Premium and Family Business Risk Premium, thus reducing the cost of capital and increasing the value of the firm.
- Knowing that the loans made to family members and booked as long-term debt on the Company's Balance Sheet will help to reduce the Company's weighted average cost of capital, the CFO encourages the financial analyst to leave this debt on the Balance Sheet.
- Based on management's own aggressive expectations for the future, the analyst is convinced that the Company's long-term sustainable growth rate in revenues is over 15% with a long-term sustainable growth rate in net cash flow to invested capital of roughly 8%. This figure is significantly higher than the Company's historic growth in net cash flow to invested capital of 3% over the last two decades.
- Having no experience in valuing a closely held and family controlled company, the analyst does not apply a discount to the value conclusion to reflect a relative lack of marketability.
- The analyst does not conduct a search of any databases for transaction data relating to closely held and family controlled companies. Rather, the analyst will base the valuation solely on the Income Approach.

Based on the financial information supplied, the financial analyst calculates that JNC Shipping Corporation's net cash flow to invested capital for the most recent fiscal year was \$3,000,000. This reflects the \$10,000 adjustment for personal expenses made to the Income Statement of the Company. Leaving the \$10 million in questionable loans on the Balance Sheet results in \$12 million for the Company's total long-term debt, as compared to \$5 million in book value equity. With no regard to the Specific Company Risk Premium or the Family Business Risk Premium, the analyst calculates a cost of equity capital of 21.4% (5% risk-free rate, 7.2% equity risk premium, and a 9.2% size premium based on data from Ibbotson Associates). The analyst further assumes that the interest rate on all of the long-term debt is 8%, including the virtually zero interest rate loans made to family members and Board members. The Company's tax rate is assumed to be 35%. These factors lead the analyst to calculate a weighted

average cost of capital of 16.1% for the Company. With a long-term sustainable growth rate estimated at 8%, the analyst calculates a capitalization rate of 8.1% or a multiple of 12.3.

Based on this, the analyst calculates a fair market value for the firm (on an invested capital and equity basis) as illustrated in the following table.

TABLE 1	
JNC Shipping Corporation	
Fair Market Value of Firm	
Net Cash Flow to Invested Capital	\$3,000,000
Capitalization Rate	8.1%
Value of Invested Capital	\$36,899,734
Less Long-term Debt	\$12,000,000
Value of Equity	\$24,899,734
Fair Market Value of Equity (rounded)	\$24,900,000
Shares Outstanding	2,000,000
Fair Market Value per Share	\$12.45

The shareholders, family members, Board of Directors, and executive management are pleased with the results of the valuation conducted by XYZ Financial Consulting Group. Based on the valuation conclusion, a majority of the shareholders vote to authorize the Board and executive management to sell the Company to a strategic buyer or a private equity group for the maximum realizable value. As such, the Company hires XYZ Financial Consulting Group to represent it in pursuit of an acquisition of the Company. Within several weeks, XYZ Financial Consulting Group has been approached by several interested buyers. XYZ Financial Consulting Group presents the buyers with a copy of the valuation report prepared for JNC Shipping Corporation as a way of establishing a minimum price level for further negotiations.

All but one of the potential buyers (Troilis International) withdraw their offers upon seeing the valuation report. Troilis International, however, is a publicly traded conglomerate based in London and controlled by descendants of its founder. The CEO, Jacqueline Nicolé, has an extensive financial background and believes that the valuation is fundamentally flawed. To rebut XYZ Financial Consulting Group's valuation, Ms. Nicolé hires a professional strategic advisory and valuation firm in the United States to conduct its own valuation as part of the preliminary due diligence. The financial analyst hired by Nicolé has extensive experience in valuing closely held and family controlled businesses, both domestic and international, and is a leading authority on the subject, having written numerous articles and several books on the topic of business valuation.

Based on the financial information provided to Troilis International during preliminary due diligence, the analyst quickly identifies the areas for potential

adjustments. Following several intense discussions with the CFO and CEO of JNC Shipping Corporation, the Company finally provides the analyst with the \$1,010,000 in personal expenses associated with the family members, Board, and management in addition to legitimate non-recurring expenses (roughly \$350,000) that had been overlooked by the analyst at XYZ Financial Consulting Group. As a result, the analyst adjusts the net cash flow to invested capital to \$4 million. The analyst also identifies the loans made to family members, Board members, and the executive management and makes the appropriate \$10 million adjustment to the Company's long-term debt.

In developing the Company's estimated cost of equity capital, the analyst applies a Specific Company Risk Premium of 4.6% and a Family Business Risk Premium of 5.0% to the 21.4% cost of equity capital estimated in the report prepared by XYZ Financial Consulting Group. This results in an estimated cost of equity capital of 31.0%. As a result of the analysis, the analyst calculates the Company's weighted average cost of capital at 27.8%. The analyst further assumes that the Company's long-term sustainable growth rate in net cash flow to invested capital is 3%, in line with its historic average and appropriate for the analyst's own reasonable forecasted earnings. The growth rate is also comparable to the growth rate experienced by other firms in the industry based on an industry analysis prepared by the analyst as part of the valuation report. With an estimated 3% sustainable growth rate, the capitalization rate is 24.8% (a multiple of 4.03). After a review of a number of studies and empirical data relating to marketability discounts and a factor analysis, the analyst estimates the appropriate lack of marketability discount applicable to the Company of 25%. This produces the value conclusion calculated in the following table:

TABLE 2	
JNC Shipping Corporation	
Fair Market Value of Firm	
Net Cash Flow to Invested Capital	\$4,000,000
Capitalization Rate	24.8%
Value of Invested Capital	\$16,128,512
Less Long-term Debt	\$2,000,000
Value of Equity	\$14,128,512
Less Marketability Discount of 25%	(\$3,532,128)
Fair Market Value of Equity (rounded)	\$10,596,000
Shares Outstanding	2,000,000
Fair Market Value per Share	\$5.30

As can be seen from the preceding table, the fair market value on a per share basis as determined by the valuation expert is 57% lower than the value produced by XYZ Financial Consulting Group. When Troilis International presents their offer for JNC Shipping Corporation based on the thorough and well-documented valuation, JNC Shipping Corporation's Board (and shareholders) reject the offer outright and stand by the flawed valuation prepared by XYZ Financial Consulting Group. Furthermore, the

shareholders are shocked and outraged by the revelations of what they consider to be corporate malfeasance and the legitimate value for the Company, given their heightened expectations stemming from the inflated valuation report prepared by XYZ Financial Consulting Group.

This case illustrates the importance of having effective corporate governance, good communication between the family members/shareholders and the executive management and Board of Directors, and experienced, credible, independent valuation professionals performing a valuation of a family owned or closely held business. In addition, family owned businesses should clearly establish how the business is to be run—as a personal piggybank or as a business managed to maximize return to its shareholders and to create transgenerational wealth.

Unqualified valuation professionals may not fully understand the dynamics of closely held businesses and the factors that drive value. Without experience in valuing closely held businesses, a financial analyst may utilize inappropriate assumptions, fail to apply the appropriate approaches and methods, and ultimately arrive at a value conclusion that is fundamentally flawed.