



Whitehall Textiles Group Case Study

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Whitehall Textiles Group was founded in 1960 by Don Whitehall to produce embroidered golf shirts and hats for corporate clients. The company thrived during the late 1960s and early 1970s as a result of three large corporate clients that each generated over \$500,000 in revenues per year for the company. These three large clients were in the energy industry, the food industry, and the tobacco industry and spent significant sums of money on advertising and promotional products. The profits generated from these three clients alone enabled the company to pay down its debt and allowed Don to take substantial distributions.

By the early 1980s, however, these clients had begun to scale back their spending on promotional products, leaving a large gap in Whitehall's revenues. In 1982, Don Whitehall was killed in a boating accident. His will left the company divided between ten of his family members. His nephew, Tharren, who had been with the company over ten years as the senior vice president of marketing and finance was his chosen successor as chief executive officer of the firm. The other nine family members had no objection to his elevation to CEO.

As the company struggled to replace the revenues it had lost from the three major clients, profitability declined substantially, prompting the company to engage in deficit spending to maintain operations and seek to expand the business. As no major customers began to emerge, Whitehall Textiles Group expanded its product line to include socks, scarves, etc. These products were typically produced in volume for private label customers and carried a much lower profit margin than the golf shirts and hats. This expansion enabled the company to break-even during the late 1980s and early 1990s. The company's debt had increased to over \$4 million as compared to total assets of \$5 million and revenues of \$7 million.

However, the passage of the North American Free Trade Agreement (NAFTA) prompted many textile producers to move operations to Mexico where non-unionized

workers were abundant, productivity was higher, and wages were substantially lower. This enabled many textile companies to obtain a competitive advantage over those producers in the United States who still sought to compete on the basis of “American Made” and higher quality. In reality, the consumers were not willing to pay more for products made in the USA, particularly if the quality of the products was not materially different than those produced in low wage countries such as Mexico.

Whitehall Textiles Group, the largest employer in its county, chose to remain in the United States and employ its relatively stable workforce. In an effort to remain competitive, Whitehall Textiles Group cut prices to match those of produces from low wage countries and increased production volume, in an attempt to compensate for further compressed profit margins by selling greater quantities. Realizing that the company needed guidance beyond the level of which he was capable, Tharren hired Jake Black, a former textile executive at a \$50 million firm who had lost his job when he opposed moving the company’s operations to Mexico. Tharren, resigned to overseeing the company as the chairman of the board, ceded operational control and the role of CEO to Jake who embarked on an ambitious program of wooing clients from his former employer. Jake also convinced the board to borrow an additional \$1 million to invest in refurbished equipment necessary to increase the output of the factory and increase the efficiency of production.

The company was again operating at a deficit, given the increased costs of servicing the firm’s growing debt burden. By the end of 2005, Whitehall Textiles Group’s debt had increased to \$9 million as compared to assets of only \$6 million. Revenues were \$10 million. Net cash flow to invested capital was \$500,000. With the company floundering under its own weight, Jake pursued a lead on a new textile material that was expected to revolutionize the industry, much as spandex had done during the 1970s. Jake put a great deal of faith in this product and began producing products using the new material for their manufacturing. This produced further losses as the material failed to catch on in the market.

Frustrated and sensing pending doom, Tharren engaged a valuation analyst to conduct a valuation of the firm for contemplation of a potential sale or liquidation. In conducting the valuation, the analyst concluded the following:

- Whitehall Textiles Group had experienced sizeable losses, resulting in a \$3 million equity loss on the most recent fiscal year end balance sheet. The analyst, however, was not totally surprised by this as many closely held and family controlled companies had negative book values as a result of managing earnings for tax purposes, etc.
- Competition in the textile industry had intensified following passage of NAFTA and the movement of textile jobs to low wage countries. For companies that chose to remain in the United States, there had been significant downward pressure on prices and profit margins.

- Productivity at Whitehall Textiles Group was significantly lower than that of the industry as a whole.
- Net cash flow to invested capital, on an adjusted basis, at \$500,000 was sub-par as compared to the industry, when looked at as a percentage of revenues.
- Net cash flow to equity (adjusted) was virtually \$0. Any deficit spending was financed using additional debt in the form of notes to Tharren and other shareholders.
- Growth expectations for revenues and net cash flow to invested capital were 4% annually, in line with that of the industry as a whole.
- Given the financial position, Whitehall Textiles Group would not likely be able to meet the balloon payments on its debt and lease agreements, which totaled over \$2.5 million, due in July of the coming fiscal year.
- The average interest rate on the long-term debt was 10%.
- A search of several transaction databases indicated that the average price to sales multiple of companies in the textile industry that had been acquired was 1.25 with a median of 1.15 and a standard deviation of 0.25.
- The marginal tax rate is 20%.

Given the relative stability of the company's net cash flow and revenues over the last ten years, the valuation analyst believes that the single period capitalization method and the direct market data method are appropriate for use in developing an indication of value. Using a build-up method, the valuation analyst computes the company's cost of equity capital at 32%. In this calculation, the valuation analyst applied a 10% specific company risk premium using a factor analysis developed by Highland Global, LLC. Based on this, the company's average interest on its debt of 10% and net cash flow to invested capital of \$500,000, the valuation analyst determines that the weighted average cost of capital is roughly 9.3%. With a 4% long-term sustainable growth rate, the capitalization rate is 5.3% or a capitalization multiple of 19.0. This produces an indication of value for the firm of roughly \$9.5 million on an enterprise basis. Removing the long-term debt produces an indication of value of the company's equity of \$500,000. Applying a lack of marketability discount of 30% based on an analysis of various factors, the fair market value estimate of the firm's equity is \$350,000.

Under the direct market data method, the valuation analyst elects to apply a price to sales multiple of 0.95, below both the average and the median. This lower multiple is based on the specific risk characteristics of the firm. Adjusting for differences in working capital, the value estimate arrived under the direct market data method is \$9.565 million on an enterprise basis. Removing the long-term debt from the value conclusion

produces an indication of the equity value of \$565,000. No discounts for lack of control or marketability are deemed necessary.

Weighting the two methods equally, the valuation analyst arrives at a fair market value of the firm's equity of \$458,000.

When assessing the prospects that the firm may have a higher value to the shareholders if liquidated, the valuation analyst decides that the value of the firm is higher as a going concern given that the firm's fixed assets with a market value of \$3.5 million (based on an appraisal of the equipment conducted by a qualified appraiser) would likely not secure a high enough price in an orderly liquidation to satisfy the firm's \$9 million in total debt.

However, the valuation analyst is not fully convinced by the value conclusion arrived through his analysis. Particularly disturbing is the abnormally low weighted average cost of capital for Whitehall Textiles Group of 9.3% as compared to an industry wide weighted average cost of capital of 14.0%. The analyst concludes that this is due to the substantial leverage used in the capital structure of the company, which helps to reduce the weighted average cost of capital and, thus, increase the value of the firm. If the firm were well managed, experienced stable profitability as measured by net income, had a positive net book value, and maintained ample interest coverage, this high proportion of debt in the capital structure would be a skillful technique to increase return on equity and maximize return for the shareholders.

In this case, Whitehall Textiles Group is obviously facing financial distress which would tend to increase the risk profile of the firm and reduce the overall value. Though the cost of equity capital was increased through the specific company risk premium to account for the risk factors of the company, the debt levels minimized this impact when calculating the weighted average cost of capital. In retrospect, the valuation analyst realized that some adjustment must be made to the firm's cost of capital to reflect the financial distress of the firm or allow this perverse relationship between the company's debt levels and weighted average cost of capital to skew the value estimate of the firm.

To correct this situation, the valuation analyst must increase the weighted average cost of capital for the firm used in calculating the value estimate under the single period capitalization method. Increasing the cost of equity capital would be an intuitively logical way of raising the weighted average cost of capital. In this case, however, the cost of equity capital contributes very little to the overall weighted average cost of capital (less than a 6% weighting); therefore, increasing the cost of equity capital even to 100% would have virtually no impact upon the weighted average cost of capital.

In light of this, the valuation analyst decides to use the industry weighted average cost of capital of 14% for valuation purposes of Whitehall Textiles Group. Based on a 14% weighted average cost of capital and a 4% growth rate, the capitalization rate is 10% with a capitalization multiple of 10.0. Using the same \$500,000 net cash flow to invested capital, this produces a value indication on an enterprise basis of \$5 million.

Removing the long-term debt, the analyst arrives at an implied equity value of -\$4 million. The analyst believes that this makes more sense given the pending financial distress of the company, its lower productivity, and its relative uncompetitive position in the market.

With respect to the direct market data method, the valuation analyst does believe that another textile company would have any interest in acquiring Whitehall Textiles Group given its financial distress, older fixed asset base, and its inability to compete effectively and efficiently.

Based on this, the valuation analyst confronts the quandary that this is a company that does not have any value left in it. It is obvious that the company is currently insolvent and could reasonably file for bankruptcy protection while it reorganizes. Even in a liquidation, some of the creditors would likely stand to lose a great deal of money. Even if an orderly liquidation enabled the company to obtain a market value of \$6 million for all of its assets (the current book value), there would still be a \$3 million shortfall in its ability to pay its total debt. This is a unique situation for a valuation analyst, but one that may occur when a company faces almost certain financial distress and is engaged in an industry that is not financial viable or attractive any longer.

As a post script, the valuation analyst presented the findings to Tharren. In an effort to help, the valuation analyst separately recommended ways to begin improving the financial health of the firm, including improving productivity, reducing unprofitable product lines, etc. Tharren received the valuation analyst's findings warmly and attempted to implement measures to save the Whitehall Textiles Group. After firing Jake Black and resuming control of the company, Tharren began cutting costs and making efforts to improve productivity. Though his efforts were a welcome change, they proved to be too little too late. In July of that year, less than six months later, Whitehall Textiles Group closed its doors, filed for Chapter 7 bankruptcy, and began liquidating the firm.