



## Patriot Industries Case Study

Robert M. Clinger III

Patriot Industries, an established textile manufacturer of embroidered golf shirts and hats, acquired Swamp Fox Industries in 1970. Swamp Fox Industries was a manufacturer of textile manufacturing equipment but also owned a manufacturer of drill bits and derricks for oil field service companies. Swamp Fox Industries continued to grow under the ownership of Patriot Industries and contributes roughly \$20 million to the Company's annual revenues of \$75 million. The division that manufactures the drill bits and derricks for oil field service companies also continued to grow, particularly in the early 2000s as oil prices rose substantially which, in turn, prompted increased exploration activity. This division, however, only contributes about \$10 million to Patriot Industries' annual revenues (half of Swamp Fox Industries' revenues) but historically has not been and is not currently profitable. As a result of the division's inability to achieve economies of scale, the net losses have mounted at the division even though revenues have increased substantially. Net income and net cash flow to invested capital at the division for the last fiscal year were (\$1,000,000) and (\$1,250,000), respectively.

In an effort to track the value created by the executive management and the long-term wealth created as a result of the execution of the Company's strategic plan, the shareholders agreed to adopt an annual valuation policy whereby an independent valuation firm would be engaged to estimate the fair market value of the Company each year. After a thorough financial analysis and extensive research, the valuation analyst concludes the following with respect to the valuation of Patriot Industries:

- It is appropriate to use the direct market data method under the market approach to value the Company. The analyst elects to use a price-to-sales ratio to develop an indication of value. Given the drag on earnings resulting from the oil equipment manufacturing division, the analyst selects a price-to-sales ratio of 0.50, which is below the median ratio of 0.70 for the entire set of transaction data relating to textile manufacturers. This produces an indication of value of \$37,500,000. When adjusting for

packaging differences (cash, accounts receivable, and accounts payable), the value indication is \$37,000,000. The analyst will weight this method 50% in determining the final value.

- The Company is relatively mature and has stable income and earnings. As a result, the analyst elects to use a single period capitalization method to develop an indication of value under the Income Approach. The Company's net cash flow to invested capital is estimated at \$5 million. The analyst estimates the Company's weighted average cost of capital at 15%. The growth prospects for the Company appear favorable, so the analyst selects a long-term sustainable growth rate of 4%. This results in a capitalization rate of 11%. This produces an indication of value of \$45,454,545.
- The Company has assets that do not fit well together—textile and textile equipment manufacturing and oil equipment manufacturing. The analyst elects to apply a portfolio discount of 10%, to both value indications, in addition to the 25% lack of marketability discount, applicable to the value indication under the Income Approach, arrived at through analysis of multiple factors. The analyst quantifies the portfolio discount by analyzing publicly traded conglomerate companies and comparing the valuation of the conglomerate to the value of the individual parts of the company. The analyst estimates that conglomerates trade at a 10% discount to the sum of their parts.

Based on this information, the analyst calculates the value of Patriot Industries in the following table:

<b>TABLE 1</b>	
<b>Patriot Industries</b>	
<b>Direct Market Data Method</b>	
Revenues	\$75,000,000
P/S Multiple	0.50
Packaging Differences	(\$500,000)
Value Indication	\$37,000,000
Weighting	50%
<b>Single Period Capitalization Method</b>	
Net Cash Flow to Invested Capital	\$5,000,000
WACC	15.0%
Less Long-term Growth Rate	4.0%
Capitalization Rate	11.0%
Value Indication	\$45,454,545
Marketability Discount	25.0%
Value Indication (rounded)	\$34,091,000
Weighting	50%

<b>Value Reconciliation</b>	
50% DMDM Value	\$18,500,000
50% SPCM Value	\$17,045,500
Value Indication	\$35,545,500
Portfolio Discount	10.0%
<b>Final Value Indication (rounded)</b>	<b>\$31,991,000</b>

However, in an effort to add value to the process for which he was engaged, the analyst also provides an indication of value were the Company to divest itself of the oil equipment manufacturing division, through either a sale of the division or by spinning the division off into a separate entity. In conducting this analysis, the analyst concludes the following:

- Once again, it is appropriate to use a price-to-sales ratio to develop an indication of value with the direct market data method under the market approach. Without the drag on earnings resulting from the oil equipment manufacturing division, the analyst selects a price-to-sales ratio of 0.80, which is above the median ratio of 0.70 for the entire set of transaction data relating to textile and textile equipment manufacturers. Removing the \$10 million revenues associated with the oil equipment division, this produces an indication of value of \$52,000,000 ( $\$65,000,000 \times .80$ ). After adjusting for packaging differences (cash, accounts receivable, and accounts payable), the value indication is \$51,650,000. The analyst will once again weight this method 50% in determining the final value. With respect to the oil equipment division, the analyst determines that the median price-to-sales multiple for the transaction data for the industry is 0.85. Based on the earnings of the oil equipment division, the analyst selects .50 as the appropriate price-to-sales ratio. This produces an indication of value of \$5,000,000 ( $\$10,000,000 \text{ revenues} \times .50$ ). Adjusting for packaging differences, the value indication is \$4,850,000.
- The analyst once again elects to use a single period capitalization method to develop an indication of value under the Income Approach. Removing the impact of the (\$1,250,000) net cash flow to invested capital associated with the oil equipment division, Patriot Industries' net cash flow to invested capital is recalculated at \$6,250,000. The Company's weighted average cost of capital is also recalculated at 13%. The growth prospects for the Company still appear favorable, so the analyst retains a long-term sustainable growth rate of 4%. This results in a capitalization rate of 9%. This produces an indication of value of \$69,444,444. The analyst does not use the Income Approach to develop an indication of value for the oil equipment manufacturing division.
- With the removal of the oil equipment division, the analyst determines that a portfolio discount is no longer appropriate. However, the 25% lack of

marketability discount arrived at through analysis of multiple factors, is still applicable to the value indication arrived under the Income Approach.

As a result, the analyst estimates the fair market value for Patriot Industries as illustrated in the following table.

<b>TABLE 2</b>	
<b>Patriot Industries</b>	
<b>Direct Market Data Method</b>	
Revenues	\$65,000,000
P/S Multiple	0.80
Packaging Differences	(\$350,000)
Value Indication	\$51,650,000
Weighting	50%
<b>Single Period Capitalization Method</b>	
Net Cash Flow to Invested Capital	\$6,250,000
WACC	13.0%
Less Long-term Growth Rate	4.0%
Capitalization Rate	9.0%
Value Indication	\$69,444,444
Marketability Discount	25.0%
Value Indication (rounded)	\$52,083,000
Weighting	50%
<b>Value Reconciliation</b>	
50% DMDM Value	\$25,825,000
50% SPCM Value	\$26,041,500
Value Indication	\$51,866,500
Portfolio Discount	0%
<b>Final Value Indication (rounded)</b>	<b>\$51,867,000</b>

The removal of the loss making oil equipment manufacturing division unlocks significant value for Patriot Industries and its shareholders by eliminating the need for a portfolio discount, increasing the price-to-sales multiple, increasing net cash flow to invested capital, and reducing the weighted average cost of capital. As the previous calculations show, the value of Patriot Industries on an enterprise level increases 62% from roughly \$32 million to \$52 million. In addition, assuming that the Company were able to sell the oil equipment division for at least \$4,850,000 to either a financial buyer or a strategic buyer (who may be willing to pay more than the estimated fair market value should there be synergies), Patriot Industries would have created additional value and generated cash to either distribute to shareholders, reinvest in the Company's growth, or pay down debt.

This example should illustrate the potential impact various discounts may have upon the value of a closely held and family controlled business. In addition, executive

management, the Board of Directors, and shareholders should carefully consider the possibility of unlocking shareholder value through a divestiture of unprofitable businesses and/or those unrelated to the firm's core operations, as these unrelated businesses may serve to depress shareholder value and destroy wealth. A closely held and family controlled company that is successful at creating transgenerational wealth is likely to realize the benefits of assessing the firm's operations and actively seeking ways to unlock shareholder value through a divestiture or spin off of unrelated business operations.