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PLAYTIME Case: Typical Baby Boomer Situation

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Abstract

The case is set at the end of 2012. The founder, sole owner, and CEO of the case company, PLAYTIME Creations, Mike Evans, had earlier in 2012 asked Darin Good, a managing director of Headwaters MB, to find a sales price for PLAYTIME since Mike is thinking about retiring, the typical baby boomer entrepreneur situation these days. Darin has solicited offers from Headwaters' network of potential buyers and 13 have made offers, ranging from $14 million to $38 million with most in the $28 million to $35 million range. Darin's tasks are now to make recommendations on price and deal structure for the sell now alternative, including the take-away cash amount, versus the hold and develop alternative. The students take the role of this Headwaters' investment banker in this case.

Darin Good is a managing director of Headwaters MB, an investment bank. One of his current clients at the end of 2012 is PLAYTIME Creations, a sculpted foam playground equipment provider. Its sole owner, Mike Evans, has hired Darin Good to provide a recommendation on whether Mike should sell PLAYTIME now or continue to hold and develop the company. Darin and his team of financial analysts at Headwaters MB have compiled the following investment information to help with this decision recommendation. Headwaters MB is an independent, middle-market investment banking firm providing strategic mergers and acquisitions, corporate finance services, and merchant banking through proprietary sources of capital. Headwaters is headquartered in Denver, Colorado with 8 regional offices across the United States with 58 principals and has strategic global partnerships with 14 firms covering 27 countries.

I. Ownership

PLAYTIME Creations, Inc. is an S corporation that Mike Evans founded in 2001, and he is still the sole shareholder. A subchapter S corporation is a corporation, but its income passes through to its shareholders where it is part of their personal income taxed at their personal rates. Mike derives most of his income and has a disproportionate percentage of his net worth dependent on the operation of this company, i.e. "sweat equity". Therefore, he is considering the possibility to diversify his holdings and form a financial relationship with an institutional investor whereby he would retain an equity stake and remain with the company to maximize the future value of his remaining equity. Alternatively, after a long and successful business career, he is thinking about just "cashing in his chips" and retiring, similar to many baby boomer entrepreneurs who are tired of "going all in" each year by reinvesting all their profits in their businesses.

Mike is a 30+ year veteran of the entertainment industry and the former owner of PLAYTIME Entertainment Inc., a shopping center-based amusement company that operates carousel rides, kiddie amusements and high-end vending equipment. He previously held several executive positions in the early years of Chuck E. Cheese, is the former President of Kiddie Rides USA and International, and is the former Vice President of Koala Corporation. With PLAYTIME Creations, Mike developed the innovative turn-key concept for bringing full-system play area solutions to the marketplace. It was his vision that brought together all the elements in what is now a standard shopping center play area: unique play features that include custom flooring,

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seating and signage in a themed environment. Having replicated this success in many new markets over the past 11 years, Mike is now focused on bringing these unique products to the global marketplace in a number of projects already landed and many more under development

II. Overview

PLAYTIME is a global provider of unique, interactive healthy play areas and sculpted foam playground equipment for indoor, outdoor, and water play venues. The company's themed soft play areas are designed to engage children, drive traffic and enhance every customer's brand. Thousands of families experience PLAYTIME every day at shopping centers, restaurants, airports, stadiums, childcare centers, healthcare centers, fitness centers, churches, resorts, recreation centers, water parks, and museums – any place that kids play. PLAYTIME is trusted by the world's most successful brands and sponsors to bring their images to life including: Sesame Street, Garfield, McDonald's, Warner Brothers, Coca Cola, LA Fitness and Life Time Fitness. PLAYTIME was a recipient of the 2010 Colorado Top Companies to Watch Award which is presented to companies that demonstrate key success factors such as employee or sales growth, entrepreneurial leadership, and a sustainable competitive advantage. The Company's sculpted foam playground equipment is unique in the industry, and the smooth finishes are naturally antibacterial, ensuring a healthy play environment for kids. They have developed commercial playgrounds that stand apart from traditional playground structures in softness, design, and usability. Each PLAYTIME play area is aesthetically themed, architect-friendly, and uniquely designed for the customer.

III. Locations and Example

PLAYTIME manufactures and installs interactive soft play areas globally with installations ranging from Alaska to Singapore, China and the United Arab Emirates. The map below provides a general idea of where PLAYTIME has installations of its playground equipment.

The picture below shows an example of one of PLAYTIME's sculpted foam playgrounds.

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Bawadi Mall -Al Ain, United Arab Emirates

IV. Investment Highlights and Information

Darin provided information to the potential buyers of PLAYTIME. The purpose was to give the investment highlights and reasons why they should submit a bid for PLAYTIME. In addition to company information, they were provided with major customer information, licenses owned, and growth opportunities. Investment highlights were divided into the following external and internal considerations and opportunities.

A. External Considerations

PLAYTIME is trusted by world-class brands and sponsors to bring their images to life, including household names like Sesame Street, McDonalds, Warner Brothers, and Coca Cola. Each PLAYTIME play area successfully drives traffic and enhances the purchaser's brand. Each interactive play area is customized to fit each customer's market, brand, vision, location, space, and budget. The company enjoys repeat business from multiple types of customers including Fortune 1000 companies and premier developers who design, build, and renovate public facilities domestically and internationally. Five-year sponsor agreements and rollouts by several domestic and international franchises further contribute to recurring revenue. The company has averaged a 20% annual sales growth rate since its inception in 2001. The high quality of their products is reflected in a warranty expense number that is only 0.5% of sales.

The surface area of PLAYTIME's products is certified to kill 99.9% of bacteria, and demonstrates resistance to fungal growth, according to the American Society for Testing and Materials (ASTM) methods G21 and E2180. PLAYTIME is the only playground company so certified which is important as customers become more conscious of health risks and possible litigation. PLAYTIME is the only company producing and selling sculpted foam playground equipment. They are the market. Entry barriers are high due to high startup costs and PLAYTIME's strong customer relationships and licenses. In addition, PLAYTIME's intellectual property strengthens the entry barriers. They own seven trademarks and sixty-two copyrights.

B. Internal Considerations

The production process used today was established several years ago when throughput was limited to \$50K - \$60K per week. The company is now producing \$250K per week utilizing a larger more effective facility, improved equipment and processes, and better trained labor

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resources. The company's throughput value per direct labor dollar has improved, but there are still opportunities through process improvements to further reduce overall production costs.

Workflow is managed effectively through the use of intricate Excel spreadsheets, but the implementation of a new material and workflow management software package would help the company be more efficient. Some of this software was recently incorporated, and improved results should be realized in 2013.

The current 65,000 sq. ft. production space is utilized at 66 % of capacity. With 20,000 sq. ft. of contiguous space available, the company could triple in size while remaining at the current facility. This excess capacity will allow the company to grow, and profit margins should increase with better utilization of the current facility. The company has $ 14.7 million in remaining backlog orders at the end of 2012. Customers pay 50% of the product price when their order is placed. The balanced is paid when the product is shipped. Then PLAYTIME has 60 days to pay its vendors which allow PLAYTIME to grow with very little need for incremental working capital. PLAYTIME's management team consists of six professionals with significant experience in building successful companies. Many members of the team are industry veterans and have worked together for over ten years.

V. Opportunities

There are several factors that provide PLAYTIME with opportunities for future growth. The recently obtained Sesame Street license is considered one of the world's best in the childhood entertainment and education market and gives the company more options to differentiate itself and its equipment. They also have a license with Garfield which allows them the ability to incorporate Garfield into play areas. PLAYTIME promotes itself as a "play pioneer" bringing the value of a play area to customer venues that had not previously considered having a sculpted foam play area. They see potential growth opportunities in the following areas:

- Retail- national and international shopping centers and big box store chains
- Restaurants- quick service restaurants and fast casual, such as McDonalds, where they are currently in about 2% of their locations
- Childcare- national childcare providers like Knowledge Universe and Goddard & Primrose
- Healthcare- hospitals, clinics, and the offices of pediatric doctors and dentists
- Fitness- fitness centers such as 24Hr Fitness, Bally's, Gold's, LA Fitness, and other independents
- Resorts, Attractions, and Recreation- national/international resorts, destination attractions such as Disney, Sea World, Six Flags, and Legoland, and zoos, museums, and water parks

PLAYTIME has installed play areas in over 50 international locations. The brand exposure, viewing opportunities, referral sources, and market traction gained from these installations in opening doors for new customers and new projects. As of the end of 2012, the company had $2 million in production backlog internationally. Management has identified a few companies that could complement PLAYTIME's product offerings and would contribute to the company's long term growth. While no acquisitions are imminent, it is under consideration.

VI. Decision Alternatives

Darin and his financial analyst team had identified the following financial information to help with Mike's decision: his total stockholder equity in PLAYTIME as of the end of 2012 was $1,461,000 and he had personally lent $20,000,000 to PLAYTIME. After circulating the

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above investment information to Headwater's extensive database of potential company buyers, there were 13 offers with the highest offer of $38,000,000 for a 100% enterprise value of PLAYTIME from a private equity firm, Silverlight Capital (see the following graph).
Mike was uncertain as to whether he wanted to sell 100% of the company now or sell a portion now and remain active in the company. He was also considering not selling any of the company at this time and working to grow the business. Darin and his financial analyst team had created the following three scenarios for Mike to consider in his sell now or hold and develop decision:

1. Sell his entire equity ownership as well as cashing out his $20 million personal loan to PLAYTIME;
2. Retain a 17% equity ownership and cash out the $20 million loan;
3. Hold and develop the company for another 5 years.

Darin had told Mike that if he decided to hold and develop PLAYTIME after 2012, the capital gains tax was scheduled to go up from its current value of 15% to 20% in 2013 or possibly to 39% if the capital gains tax rate is eliminated for taxable income over $200,000, which Mike would achieve whenever he sold his business. Condensed versions of PLAYTIME's 2012 Income Statement and Balance Sheet are shown below. After consulting with Mike and reviewing PLAYTIME's historical income statements and balance sheets, Darin's financial team reviewed and found reasonable the following income statement projections for 2013 through 2017. Sales will grow at an annual rate of 20% which is the company's average annual growth rate since its inception in 2001 and to be conservative, slightly below the average of the last three years' value. The past statements showed that sales had grown 16%, 21% and 24% in the last three years. EBITDA will be 23.3% of sales. The team discovered that the balance sheet did not include the personal loan from Mike of $20 million for a one-time expansion of PLAYTIME's plant and equipment.

Income Statement
Figures (in thousands)

	Actual	**Projected**				
	2012	**2013**	**2014**	**2015**	**2016**	**2017**
Sales	$21,700	$26,040	$31,248	$37,498	$44,997	$53,997
Gross Profit	$10,605					
Operating Expenses	$5,747					
EBITDA	$4,858	$6,067	$7,281	$8,737	$10,484	$12,581

Balance Sheet
2012 Figures (in thousands)

Total Assets	**Total Liabilities**	**Shareholder's Equity**
$5,518	$4,057	$1,461

Darin had told his financial analyst team that this PLAYTIME situation was typical when baby boomer entrepreneurs were getting ready to retire. He had seen his client list of potential business sellers grow each year, even during the recent recession years. The recent trouble in closing deals was that there was no "L" in "LBOs" for potential business buyers to finance deals. He mentioned one equity partner acquaintance who said his business purchases all had to be in cash until last year when bank financing was becoming available again. Also, he noted

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that the uncertainty in the capital gains tax situation was motivating some buyers to sell now before the Bush tax cuts expired at the end of 2012. If the PLAYTIME deal was completed this year, Headwaters' fee would be $1.6 million or 4.2% of the $38 million price.

Darin also told his team that the market (multiple) approach to business valuation was his preferred strategy for representing these "sell side" M&A deals since current market prices were used. Accordingly, he had used multiples for valuations in over fifty such deals in his career as an investment banker. Two of Darin's frequently used sources for determining the appropriate multiples to be used are "Forward Thinking, Successful Ideas" in Business Advisor, Spring 2006 and "The Fallacy of Safe Harbors: Managing Value in the Private Firm" in Strategic Finance, April 2006. While these two articles were published in 2006, he feels that their information is still appropriate for 2012. In 2006, the financial markets had recovered from the technology crash of the early 2000s. In 2012, the financial markets have recovered from the financial crisis of 2008-2009. In Darin's opinion, the 2012 market place for valuations should have similar multiples to the 2006 period. He has also used other financial data sources such as S&P's Capital IQ and BVR (Business Valuation Resources) to get multiples.

However, Darin told his team that a discounted cash flow (DCF) valuation should also be done, using the Headwaters' DCF approach. Headwaters' experience with DCF valuations has shown that they can often result in business valuations considered to be too large. Thus, the Headwaters' strategy when doing DCF valuations is to be very conservative, using a 5 year forecast horizon with a terminal value, and considering EBITDA to be a good proxy for cash flow. The terminal value calculation uses a multiple of 5 on the year 5 cash flow, assuming that it will continue forever but with no growth.

Also, the discount rate used in the DCF calculation is very conservative. It is derived from the Security Market Line in the Capital Asset Pricing Model. Headwaters' analysts use the 20-year Treasury Bond rate for the risk free rate which was 3% in 2012. Morningstar's *Stocks, Bonds, Bills and Inflation* publication is commonly used to get the market risk premium. The 2012 Classic Version shows that for the time period 1926 through 2011, the average market premium has been 8.2%. While PLAYTIME has been successful and its products have little competition, the uncertainties of the playground market and the potential for future changes in preferences caused the Headwaters analysts to recommend a beta of 2.5. As one final conservative measure, Headwaters always adds 5% to the value derived from the Security Market Line.

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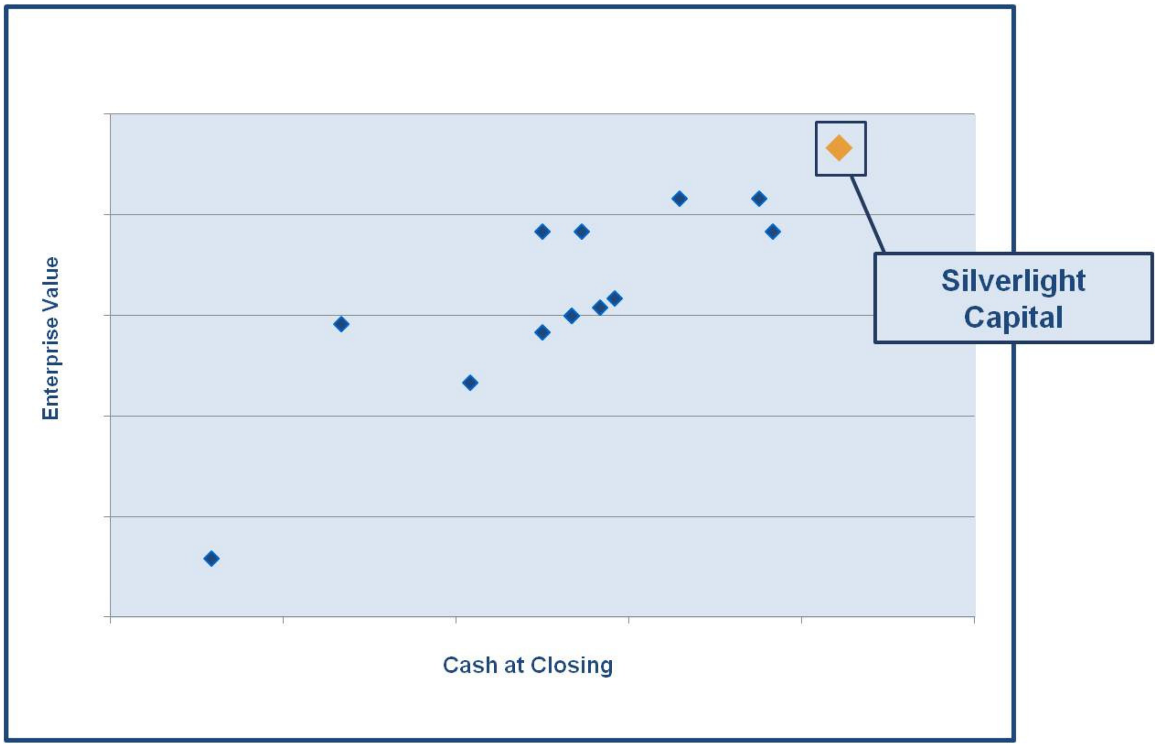

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