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VALUATION ISSUES™

Klaris, Thomson & Schroeder, Inc. **2006-2**

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WorldCom Group
By Todd F. Hollingshead, ASA

KTS was engaged to opine on the validity of a certain Wall Street Firm's ("Firm") valuation and discounted cash flow (DCF) models prepared by their top analyst and assistant relative to WorldCom Group from early 2001 through the downgrade of WorldCom Group for the first time in April 2002. The purpose of the report was to assess the reasonableness or unreasonableness of the allegedly misleading recommendations for litigation purposes. We represented New York City Funds, The Retirement Systems of Alabama, and certain private investors.

Background

The telecommunications industry as a whole, and WorldCom in particular, experienced sharp and continuous declines in share prices and WorldCom common stock fell from a high on June 30, 1999 of $96.766 per share to a low of $46 per share by June 30, 2000. As of December 29, 2000, the stock's high was $18.656. For the next year, it generally fluctuated between $12 and $24 per share. It fell precipitously in 2002 and was delisted from the NASDAQ stock market as of July 30, 2002.

Up until April 2002, the analyst and the firm repeatedly gave WorldCom's stock its highest ratings, enthusiastically urging investors to purchase WorldCom shares, even at times when the analyst was privately advising WorldCom management on business strategy, acquisitions, and investor relations.

The analyst consistently maintained that WorldCom represented the cheapest S&P large-cap growth stock at the time, remained the "must-own" large-cap growth stock in anyone's portfolio, represented one of the premier large-cap growth companies in any industry, and represented the single best idea in telecom. The analyst urged investors to "load up the truck" with WorldCom stock. In fact, the analyst declared that any investor who did not take advantage of current prices to buy every share of WorldCom should seriously think about another vocation.

The firm's first downgrade of WorldCom stock came in April 2002. In May 2002, the analyst further downgraded his risk rating to speculative in response to the deterioration of WorldCom's debt ratings. A final downgrade, to "underperform-speculative," followed on June 21, 2002, a little over a month before WorldCom's filing for bankruptcy.

By then, WorldCom shareholders had lost more than $180 billion in market capitalization since 1999. Conversely, from 1998 until 2001, when he consistently encouraged investors to buy WorldCom's stock, it is alleged that the analyst reportedly averaged approximately $20 million per year in compensation.

> **"...WorldCom shareholders had lost more than $180 billion in market capitalization since 1999."**

The analyst was at all relevant times a leading securities analyst in the telecommunications industry. Because of his reputation and influence, the analyst's reports for the firm carried significant weight with public investors, such that a favorable report could send the price of a company's stock upward. Money managers hailed him as "the ax"- the most influential analyst in his sector. According to The Wall Street Journal's "Heard On The Street" article of April 12, 2002, the analyst "gained the image of a swashbuckling deal maker who can sometimes make or break a telecom merger or stock offering."

Structure and Methodology of DCF Models

We concluded that the analyst's DCF models were structurally and methodologically adequate based upon generally accepted valuation practices.

Projected Revenues

WorldCom Group's revenues increased significantly from 1998 through 2000. Much of this increase stemmed from acquisitions. However, WorldCom Group's revenues growth began to slow after December 31, 1999 and began to continually decrease after March 31, 2001. Although the analyst's revenues growth projections were adjusted downward, they were still not reflective of WorldCom Group's declining revenues over the March 31, 2001 through 2002 time period, and the compound annual growth rate (CAGR) realized for total telecom revenues.

Earnings Margins

The analyst's models had EBITDA compound annual growth rates (CAGR) much greater than the actual compound

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WorldCom Group
(Cont.)

annual growth rate during the December 31, 1999 through 2001 period.

Assumed 2010 Future Value (FV)/ EBITDA Multiple

The analyst's WorldCom Group FV/ EBITDA multiple range selection decreased by approximately half in less than a year. In his earlier models, more than 90% of WorldCom Group's value came from the present value of perpetual cash flow, which suggests that his multiples were grossly inflated. In his later models, 65% to 70% of WorldCom Group's value came from the present value of perpetual cash flow, which suggests that the multiple range was more accurate (more reasonable). In the analyst's earlier models, his FV/EBITDA multiple range selection was substantially higher than actual multiples, but falls more in line in the later models.

Implied 2010 Price/Earnings (P/E) Multiple

The analyst's P/E multiple range selection decreased by nearly half in less than a year. The analyst's selected implied 2010 P/E multiple range was more than 1.5 times the 2009-2010 growth rate and above the 10 year growth rate in his earlier model, but falls somewhat in line with the later models. In the analyst's earlier models, his 2010 P/E multiple range selection were substantially higher than actual multiples, but fell more in line in the later models.

Weighted Average Cost of Capital (WACC)

The discount (WACC) rates utilized by the analyst in his earlier models are somewhat below what we believed to be appropriate discount rates; however, his selected discount rates in his later models are below what we believed to be appropriate discount rates. We compared the analyst's discount rates at the time of two of his late 2001 DCF models with Aaa and Baa Moody rated corporate bonds at the same dates. Based on the figures, the analyst considered WorldCom Group stock (equity) relatively as safe as Aaa and Baa Moody rated corporate bonds. It did not make sense, especially at the state of WorldCom Group during the aforementioned two dates.

The Analyst's Recommendations

The analyst continually rated WorldCom Group stock a 1M rating (1 = buy, 2 = outperform, 3 = neutral, 4 = underperform, 5 = sell; and L - low risk, M = Moderate risk, H = high risk, S = speculative, V = venture) up through March 12, 2002 when WorldCom Group was removed from the recommended list. In January 2002, WorldCom Group's debt rating was lowered to a BBB rating. In the analyst's March 18, 2002 report, he still had WorldCom Group stock at a buy, but high risk (1H). A little over one month later, in the analyst's April 21, 2002 report, he downgraded WorldCom Group stock to 3H (neutral, high risk). Finally, in the analyst's May 22, 2002 report, he again downgraded WorldCom Group stock to 3S (neutral, speculative) and further downgraded it to 4S (underperform, speculative) in his June 21, 2002 report just before WorldCom Group filed for bankruptcy on July 21, 2002. While the analyst continued to rate WorldCom Group stock at a 1M rating (buy, moderate), WorldCom Group's financial performance was diminishing and its stock price was decreasing.

"Overall, all of these findings suggested that the analyst had overvalued WorldCom Group stock over the relevant period."

Summary

The analyst's DCF models were structurally and methodologically adequate based upon generally accepted valuation practices. However, during the relevant period, his revenue projections and earnings margins were unrealistically optimistic; his selection of assumed FV/EBITDA multiples and implied price/earnings (P/E) multiples were unrealistically optimistic in the earlier models, but fell in line in the later models; his selection of weighted average cost of capital (WACC) was too low in all of the models; and his recommendations were unrealistically optimistic. The inputs in his models became more unrealistically optimistic when comparing his earlier models with his later models suggesting that he was attempting to inflate or maintain stock prices. Overall, all of these findings suggested that the analyst had overvalued WorldCom Group stock over the relevant period.

In a June 21, 2001 e-mail to the analyst from his assistant, she states "Don't forget you taught me that tracker stocks are financial engineering."

We never understood Wall Street's meaning of financial engineering; however, it appears that, based on many current public investigations on Wall Street, financial engineering is other than unbiased (independent) valuation.

Unbiased valuation can be very difficult in the midst of perceived or actual conflicts of interests and judgement must be tempered with common sense and not wishful thinking.

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The Final Valuation
KTS Analysis of Cemetery Crypts and Niches
By J. Stanley Urquhart, MBA

There are some things we do immediately, and there are some things we like to put off because they are, well... unpleasant to consider. One thing that most of us would prefer to put off is death. I was recently the point man for KTS's valuation of a mausoleum which contains crypts and niches. Since the Los Angeles office of Klaris, Thomson, and Schroeder has specialization in both real estate and business valuation, we were an ideal valuation firm for this project.

In the past, mausoleums were built to entomb and honor the Pharaohs and other people who were rich and powerful. Today, space in a mausoleum is affordable to middle class Americans. For crypts, one can think of a mausoleum as a condominium complex for the deceased, with ventilation systems to help exhume the fumes that build up from decomposition of the remains. Niches are places to store cremated remains, they

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The Final Valuation
(Cont.)

may be entombed in a mausoleum or given other placement. After the movie 'Meet the Parents,' which contained a catastrophe involving the cremated remains of a character's relative, I imagine the demand for entombment increased.

One approach to valuation is to compare the subject to entities in a similar market. This is called the market approach. The mausoleum was valued by comparing the current price structure of crypts and niches with those in other mausoleums in the Los Angeles area. After a base value is established, price premiums are given to each crypt and niche based on its location and level in the mausoleum.

Location refers to where in the mausoleum or cemetery, the crypt, or niche is located. One example of location premium is to have your remains placed next to someone famous. Hugh Hefner paid a premium for his final resting place next to Marilyn Monroe in the Westwood Memorial Park. In addition, there is also a location premium to be entombed next to civil rights pioneer Rosa Parks at the Woodlawn Cemetery in Detroit. In the Crystal Cathedral Cemetery and Mausoleum, located in Orange County California, the most prominent locations are nearest to where church leader Dr. Schuller will be buried. The more valuable mausoleum walls face the glass tower, providing the mourner (and perhaps the deceased) with a more peaceful view which allows them to more fully appreciate the experience of visitation.

For niches, the Crystal Cathedral has a room of reflection, where premium niches create a pattern in stained glass that replicates a cross. Those whose ashes are entombed include Marie Callender, the woman whose pies gave us so much joy.

A level premium is similar to a location premium. Just as a tenth story condominium in a building may be worth a different amount than a similar one on the second story, the crypt or niche is valued based on its level. The market information we collected indicated the different premiums we would place on each level from our base value. Physically, the lowest level is the ground

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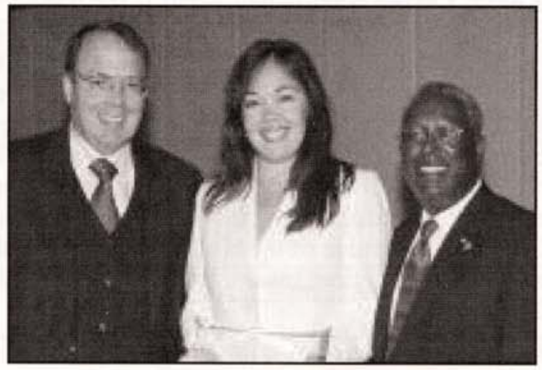

Alfred P. Sloan Award Picture: From Left to Right, John A. Thomson, V.P. Managing Director, Klaris, Thomson & Schroeder, Inc., Anita Thomson, Marketing Director, Klaris, Thomson & Schroeder, Inc. and Larry Whitley, Director, Boeing 767 Tanker Communications, Boeing Integrated Defense Systems and Chairman of the Chamber of Commerce Board of Long Beach, CA.

KLARIS, THOMSON & SCHROEDER, INC.
Receives Recognition for Flexibility and is Awarded the
Alfred P. Sloan Award
for Business Excellence in Workplace Flexibility

by Anita Thomson, Marketing Director-L.A.

The Los Angeles office of Klaris, Thomson & Schroeder, Inc. was recognized April 20, 2006 at the Long Beach Chamber's Business Forecast 2006 Conference as one of five selected top practitioners of workplace flexibility in the nation.

The Alfred P. Sloan Award for Business Excellence in Workplace Flexibility is part of the When Work Works project, an ongoing initiative of Families and Work Institute, the Center for Workforce Preparation, an affiliate of the U.S. Chamber of Commerce, and the Twiga Foundation to recognize businesses that are dedicated to making work "work" for the employer and the employees. Through When Work Works, these partner organizations provide research, resources and recognition to businesses nationwide, and share the results of the research on creating effective and flexible workplaces that meet the needs of the 21st Century.

The When Work Works initiative awards the Sloan Awards for Business Excellence in Workplace Flexibility to companies that have successfully used flexibility to meet both business and employee goals. Using a rigorous methodology that includes employees' views as well as employer practices in its scoring, the Sloan Awards honor organizations that have made real commitments to using workplace flexibility as a tool to enhance business and employee's success.

The Alfred P. Sloan Foundation's Workplace Flexibility Initiative is a collaborative effort designed to make workplace flexibility the American standard. It is based on 10 years of research revealing the benefits of workplace flexibility for employers and employees alike. The Foundation funds a variety of projects at the national, state and local levels that coordinate with business, labor, government and advocacy groups to advance flexible work arrangements.

Winners of this prestigious award, however, not only represent companies that offer excellent workplace flexibility policies and practices, but they also represent organizations that use flexibility as a strategic business tool to benefit business and employees.

Klaris, Thomson & Schroeder, Inc. would like to thank When Work Works, Families and Work Institute, the Center for Workforce Preparation, an affiliate of the U.S. Chamber of Commerce, the Twiga Foundation and the Long Beach Chamber for the recognition and presentation of such a recognized and honorable award.

level, and this level tends to have the second lowest value. The next level is the thigh level, and that is slightly higher in value. The highest values are what they call the heart and face levels, where the mourner can reach out and touch the crypt or niche without bending or stretching. The next level up is called the sky level, and the prices there tend to be less than ground level, because the mourner can't touch the crypt or niche as easily.

I also encountered crypts for sale on a 'preconstruction' basis. Given that the date of occupancy is more flexible for the living than for the dead, I asked what would occur if the need for space arose before the crypt was completed. I was told that there would be the complimentary option of cold storage during construction.

In California, the prices generally include a contribution to an endowment, which should provide the resources to maintain the property for eternity. Our Lady of Angels Cathedral in Downtown Los Angeles uses the proceeds from the sale of the crypts and niches to fund an endowment to take care of the cathedral itself, providing permanence for the mourner in this world and the next.

Crypts, niches, and cemetery plots are not very liquid investments. From an investment standpoint, they are not very profitable either. Per the Motley Fool investment website, the value of a crypt or niche tends to appreciate less than the alternative of market investments. This conforms with information KTS found on appreciation: During one of the hottest real estate markets in Los Angeles, California, the value of these properties even underperformed the Consumer Price Index.

Before I started this investigation, I was a little bit nervous with the subject matter. Today I can say I am more at peace with my final piece of real estate.

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KTS CALENDAR

RECENT AND UPCOMING SEMINARS AND SPEAKING ENGAGEMENTS

5/4&5/12	Illinois Institute for Continuing Legal Education—Springfield and Chicago, IL.
6/7/06	Booth—55th Annual Tax & Estate Planning Forum, New Brunswick, NJ.
6/8-6/10	Booth—Missouri Bar Association-Solo and Small Firm Conference, Lake Ozark, MO.
7/27/06	Advanced Partnerships, LLCs and LLPs: Organization and Operation in California—Sheraton Hotel, Pasadena, CA.

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"You will never find time for anything. If you want time you must make it."

- Charles Buxton