



# PRELIMINARY VALUATION CENTRAL SUMTER UTILITY COMPANY

October 2019

Prepared for:

North Sumter County Utility Dependent District

Prepared on October 15, 2019

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## PRELIMINARY VALUATION of CENTRAL SUMTER UTILITY COMPANY, LLC

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### 1.0 Executive Summary

The North Sumter County Utility Dependent District (“District” or “Buyer”) is considering the purchase of Central Sumter Utility Company, LLC (“CSU” or “Seller”). The District and the Seller have executed an Agreement for Purchase and Sale dated September 19, 2019 (the “Agreement”).<sup>1</sup> All capitalized terms in this report are defined in the Agreement.

Section 5 of the Agreement governs the Purchase Price. The Agreement calls for the District and the Seller to each retain a valuation consultant to determine the value of CSU based on the following instructions contained in the Agreement.

“It is agreed that the True Interest Cost associated with the issuance of the Purchaser’s Series 2019 Bonds (“the Bonds”) as reasonably estimated and provided by the Senior Managing Underwriter shall be [ \* ]% for the purpose of Preliminary Valuation.”<sup>2</sup> Essentially, this valuation instruction is tantamount to utilizing the income approach to value using the True Interest Cost (“TIC”) as the discounting factor with additional adjustment to reflect the special financing considerations expected for the transaction outlined in the Agreement.

Also, as noted in the Agreement, both Seller and Purchaser agree that if the lesser of the two Preliminary Valuations is not greater than 5% less than the higher valuation, then the Purchase Price shall be established at the lesser of the two Preliminary Valuations. If the lesser of the two Preliminary Valuations is greater than 5% lower, but not greater than 10% lower of the higher of the two Preliminary Valuations, then Purchaser and Seller agree that the Purchase Price shall be established at the average of the two Preliminary Valuations. If the lesser of the two Preliminary Valuations is greater than 10% lower than the higher of the two Preliminary Valuations, then the Seller and the Purchaser shall meet in an attempt to reconcile an agreed upon determination of value. If, after such reconciliation is received, the Purchaser or Seller determines that it is not in its interest to conclude the purchase contemplated by the Agreement, then the party may terminate the Agreement.

The Buyer retained PFM Financial Advisors LLC (“PFM”) as its valuation consultant. Using the income approach PFM has come to a Preliminary Valuation for CSU of **\$93,880,000 as of October 15, 2019.**

Finally, the amount that the Seller may receive may vary from the Preliminary Valuation as a result of other deductions and credits as discussed herein. PFM’s Preliminary Valuation of CSU is provided below.

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<sup>1</sup> Agreement for Purchase and Sale (September 19, 2019) between Central Sumter Utility Company, LLC and North Sumter County Utility Dependent District.

<sup>2</sup> Agreement, page 11.



## 2.0 Central Sumter Utility Company, LLC

### 2.1 Service Area

The Central Sumter Utility Company, LLC (CSU) owns and operates both water and wastewater utility systems within an area as approved by the Florida Public Service Commission (FPSC) which consists of approximately 6,315 acres currently located within unincorporated Sumter County, City of Wildwood and City of Fruitland Park, commonly referred to as the CSU Service Area. It is generally located between County Road 466A to the north and State Road 44 to the south.<sup>3</sup> The Service Area is part of The Villages, one of the fastest growing metropolitan areas in the U.S.

As provided in the “2019 Engineering Report for the Sale of Central Sumter Utility Company, LLC Water and Wastewater Systems”, dated October 15, 2019 (“Engineer’s Report”) prepared by Farner, Barley and Associates, Inc., the CSU Service Area is planned to consist of 13,859 residential dwelling units and approximately 356 general commercial connections at development build-out. As of August 2019 the CSU Service Area provided water and wastewater services to 13,678 residential dwelling units and 244 general commercial connections.

The FPSC has issued CSU Certificates No. 631-W and No. 540-S to provide water and wastewater services in accordance with the provisions of Chapter 367 Florida Statutes.

Irrigation water for all residential yards, commercial and common landscaped areas is provided by Sumter Water Conservation Authority (SWCA), a separate utility. The SWCA serves the Service Area irrigation and fire flow demand separate and apart from the CSU system.<sup>4</sup>

### 2.2 General Description

According to the Engineer’s Report CSU is responsible for providing potable water supply, treatment and distribution as well as wastewater collection, treatment and disposal for a portion of The Villages located within the CSU Service Area. As of August 2019, CSU served 13,678 residential customers with an estimated population of 25,988 based on 1.9 people per residential home. The 1.9 people per residential home is based on historic data provided by The Villages and has been accepted by the Florida Department of Economic Opportunity as a reasonable estimate for retirement communities.

Construction of the CSU water and wastewater infrastructure began in 2010. The infrastructure is 8 years old or less and is in excellent condition per the Engineer’s Report. The water treatment facility (WTF) was taken out of service in September 2013 due to infrequent high levels of iron being produced by the wells. Due to the infrequent high level of iron content periodically being produced, CSU designed, permitted and constructed an iron removal system which was placed into service in March 2015. The wastewater treatment facility (WWTF) is complete, and has been in service since 2012, no substantial repairs or modifications are anticipated in the near future. The water distribution system and wastewater collection system infrastructures throughout the Service Area are 100% complete.

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<sup>3</sup> 2019 Engineering Report for the Sale of CSUC, LLC Water and Wastewater Systems, 10/3/2019, Farner, Barley and Associates, Inc., page 6.

<sup>4</sup> 2019 Engineering Report, Op. Cit.



## 3.0 Valuation Methods

### 3.1 Metrics of Value

There are a number of recognized definitions of value<sup>5</sup>. The appropriate definition of value depends in part on the purpose for the valuation. For example, in some circumstances the definition of value is determined by law, either because of statutes or contracts. In other circumstances the metric of value depends upon the wishes of the parties involved. Recognized professional definitions of value include: (a) fair market value, (b) investment value, (c) intrinsic or fundamental value, and (d) fair value.<sup>6</sup>

Fair market value is well defined by IRS ruling 59-60 as "...the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts. Fair market value is measured in cash terms, in U.S. currency, at the valuation date, based on then current market conditions.<sup>7</sup>

Investment value is defined as "the specific value of an investment to a particular investor or class of investors based on individual investment requirements; distinguished from market value, which is impersonal and detached."<sup>8</sup> Often this involves the calculation of value based on discounting an anticipated stream of future cash flows. There are a number of valid reasons why investment value may differ from fair market value including: (a) differences in estimates for future earnings, (b) differing perceptions of risk, (c) varying income tax situations, and (d) synergies with other operations owned or controlled by the investor. Finally, it is important to note that investment value is not divorced from fair market value. Markets are composed of many individual investors, each of whom make their own calculations of what they are willing to pay for an asset and at what price they are willing to sell. Collectively the decisions of all of these individual investors make up the marketplace in which fair market value is determined.

Intrinsic or fundamental value is a measure of the real worth of an asset, and so it is an analytical judgment of value based on the perceived characteristics of the asset. Intrinsic value typically comes up in the analysis of securities. Security analysts conduct fundamental analysis of a company's operations, assets, management, markets, and other factors to arrive at the fundamental or intrinsic value of the security. If the market price is higher than the estimated intrinsic value, this is a sell signal and vice versa.<sup>9</sup>

Finally, fair value is a concept that arises most often in shareholder disputes. In many states when a corporation or partnership merges, sells out, liquidates, or takes other major actions forcing a minority owner to accept what he considers less than adequate compensation, he may have the right to have his interest appraised and to receive fair value. Thus, fair value is calculated immediately prior to the action that the dissenter objects to.

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<sup>5</sup> Pratt, Shannon et al., (1998), Valuing Small Businesses and Professional Practices, McGraw-Hill: New York, New York, page 38.

<sup>6</sup> Pratt, Op. Cit., pages 38-45.

<sup>7</sup> Pratt, Op. Cit., pages 48-41.

<sup>8</sup> Chicago Appraisal Institute (1993), The Dictionary of Real Estate Appraisal, 3<sup>rd</sup> Edition, page 190

<sup>9</sup> Pratt, Op. Cit., pages 43-45.



Regardless of the standard of value selected, there are four alternative premises of value each of which are appropriate in differing situations. First, is “going concern” value which to value the entity as an ongoing business concern. Second, is to value the entity as an “assemblage of assets,” as a group of assets in place, but not used to produce income on an ongoing basis. Third, “value in an orderly disposition” is where the assets are sold on an individual basis, with reasonable market exposure, in normally operating secondary markets. Finally, “liquidation value” is where the assets are sold individually without normal market exposure in their secondary markets.<sup>10</sup>

Based on our understanding of CSU’s business and the market in which it operates, and considering the potential purchase of CSU by the District, PFM concludes that the appropriate metric of value for this assignment is fair market value. PFM recognizes that the District is a governmental unit formed to provide services to residents and businesses under its jurisdiction for their benefit. Therefore, valuing CSU using the investment standard of value would also be a valid approach. However, the District is under no obligation to purchase CSU and would do so only if such purchase was in the best interests of its constituents.

With respect to the premise of value, PFM recognizes that CSU is a going concern. Seller is not liquidating CSU and is under no compulsion to sell. Therefore, the going concern basis is the correct form for this valuation of CSU.

Finally, while the definitions for fair market value and going concern value are clear, the actual valuation process is more complicated. IRS ruling 59-60 describes some the particulars that make each valuation unique. These are as follows:

A determination of fair market value, being a question of fact, will depend upon circumstances in each case.

- i) No formula can be devised that will be generally applicable to the multitude of different valuation issues...
- ii) A sound valuation will be based on all the relevant facts, but the elements of common sense, informed judgment, and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

### 3.2 Approaches to Value

Similar to real estate appraisers, business valuation professionals utilize three approaches to valuing a business: 1) cost, 2) market, and 3) income.<sup>11</sup> However, as discussed above in Section 1, the Agreement explicitly calls for valuation using the income approach to value.

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<sup>10</sup> Pratt, Op. Cit., pages 46-48.

<sup>11</sup> Pratt, Op. Cit., page 197



### 3.3 Income Approach

The income approach to valuation is based on the principle that the value of ownership interest in a company or asset is equal to the present worth of the future benefits of ownership.<sup>12</sup>

There are two basic types of income valuation methods:<sup>13</sup>

- 1) Discounted future returns method and
- 2) Capitalized returns method

The discounted future returns method discounts the future earnings or cash flows back to the valuation date using the present value method. The capitalized returns method is a shortcut for the discounted future returns method and applies a discount rate to a single number representing cash flow or earnings.<sup>14</sup>

Both methods are acceptable to use since the capitalized return method is just a shortcut of the discounted returns method. However, the discounted returns method is typically used when future operations generate significantly different earnings or cash flows than current operations. In addition, if future earnings were to be volatile the discounted returns methods would be more appropriate. The capitalized returns method is appropriate when future earnings are expected to be stable or to grow at a fairly constant rate.<sup>15</sup>

In PFM's opinion, the most important element for the income based approach is a reliable pro forma forecasting future earnings or cash flows. CSU has supplied the PFM with prior financial statements of the utilities to be acquired. At this time, no forecast five-year pro forma has been provided by CSU. PFM has reviewed the prior financial statements.

Based on the specific circumstances of CSU, PFM concluded the discounted cash flow approach to valuation is appropriate for valuing CSU. CSU's cash flows are projected to increase through 2019 as the Service Area continues its buildout and as scheduled rate increases are implemented. These projected increases in future cash flow makes the capitalization approach inapplicable.

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<sup>12</sup> Fishman, Op. Cit., page 2-9.

<sup>13</sup> Fishman, Op. Cit., page 2-10.

<sup>14</sup> Fishman, Op. Cit., page 2-7.

<sup>15</sup> Fishman, Op. Cit., page 2-9.



## 4.0 Preliminary Valuation of Central Sumter Utility Company, LLC

### 4.1 Projections from 2019 through 2050

As noted above, the Agreement requires that the present value of the future cash flow of CSU is calculated using the TIC as reasonably estimated and provided by the Senior Managing Underwriter which will fund the District's purchase of CSU. However, the present value of CSU's future cash flow is not to be confused with the value of CSU using the income approach to value. Simply calculating the present value of the CSU's future cash flow at the TIC rate would overstate the value of CSU. Such an approach would ignore the particular circumstances of the District's Series 2019 Bond issue which gives rise to the TIC. Without the Series 2019 Bonds there would be no TIC.

At this time, the TIC for the Series 2019 Bonds as reasonably estimated and provided by the Senior Managing Underwriter, Citigroup Global Markets, is 4.00%. The financing structure includes the standard features of a municipal bond issue including provision for a debt service reserve account, cost of issuance and underwriter's discount all of which are necessary to sell the bonds and all of which reduce the funds available to the District to purchase CSU. In addition, the PFM's Preliminary Valuation assumes a senior tranche of Series 2019 Bonds which will have a coverage ratio of approximately 1.20 times debt service and a junior tranche of Series 2019 Bonds with an approximate 1.05 times debt service coverage. In addition to the debt service coverage, the senior tranche incorporates a 3% renewal and replacement fund ("R&R Fund") while the junior tranche incorporates a 4% R&R Fund. These coverage requirements and R&R Fund reduce the funds available to the District to purchase CSU.

CSU's cash flows are projected to increase through 2019 as the Service Area continues its buildout. Based on the residential and commercial development trends, PFM forecasts the Service Area buildout through 2032. The remaining 181 residential units within the residential component of the Service Area is estimated to buildout in 2021 and the balance of 356 general commercial connections (112 commercial connections) is forecast to buildout in 2032. Per information provided by the District, the projected annual growth rate for underlying utility system rates is 2.5% through 2025. The anticipated annual growth rate for the utility system rates beyond 2025 through 2050 is 1.5%.

### 4.2 Derivation of the Discount Rate

To estimate the value of CSU using the discounted future returns method, the future flow of net operating income (NOI) as adjusted is discounted to its present value. Discount rates are widely used in economics, finance and accounting to reduce a future stream of values (be they incomes, costs, profits, or the like) to their present value. A discount rate is designed to include provision for all of the risks associated with the future cash flow to be discounted.<sup>16</sup> The time value of money is represented by the risk free rate of interest, but this does not incorporate any other risks associated with the expected event or payment.<sup>17</sup> In this case, PFM is utilizing a discount rate of 4.00% for this Preliminary Valuation. This is consistent with the estimate of the Senior Managing Underwriter.

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<sup>16</sup> Hitchner, James (2011), Financial Valuation, Hoboken, NJ: John Wiley & Sons, page 966.

<sup>17</sup> American Academy of Actuaries (September 2009), "Discussion on the Use of Discount Rates in Accounting Present Value Estimates", page 4 [http://www.actuary.org/files/publications/discount\\_091509.pdf](http://www.actuary.org/files/publications/discount_091509.pdf)



### 4.3 Value of the Purchased Assets Using the Income Approach

Table 2 provides the detailed calculations supporting a preliminary value of \$100,710,000 for CSU.<sup>18</sup> The net cash flow projected for CSU includes the 32-year period from 2019 through 2050. This is consistent with the typical 30-year amortization period and two years of deferred principal and capitalized interest which are often included in similar municipal bond issues underwritten in Florida. This 32-year period is also reasonable given that CSU's system is newly established with future construction anticipated through 2019 and beyond. PFM believes this is the shortest period appropriate for valuing CSU.

Table 1 summarizes the net present value of CSU's anticipated future cash flows from 2019 through 2050 totaling \$100,710,000 calculated using the estimated TIC as provided herein. The deductions for the debt service reserve, cost of issuance and the underwriter's discount result in the net Preliminary Valuation of \$93,880,000 for CSU. Given the stage of buildout, capitalized interest was not deducted.

**Table 1. Summary of Preliminary Valuation of Central Sumter Utility, LLC**

Par Value of Series 2019 CSU	\$ 100,710,000
Debt Service Reserve Fund (100% MADS)	\$ 5,820,000
Capitalized Interest Fund	\$ -
Cost of Issuance	\$ 250,000
Underwriter's Discount	\$ 755,325
Capital Expansion Fund	\$ -
	=====
Acquisition Fund	\$ 93,880,000

Source: PFM Financial Advisors LLC

<sup>18</sup> Cash flows are extended through 2050 and are shown in Table 2.



Table 2. Detailed Preliminary Valuation of Central Sumter Utility, LLC

	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>2026</u>	<u>2027</u>	<u>2028</u>	<u>2029</u>
<u>Senior Debt</u>											
Funds for DS	\$566,820	\$4,658,320	\$4,816,698	\$4,965,845	\$5,114,609	\$5,268,261	\$5,423,131	\$5,521,351	\$5,613,976	\$5,704,719	\$5,796,921
DSC	\$113,364	\$931,664	\$963,340	\$993,169	\$1,022,922	\$1,053,652	\$1,084,626	\$1,104,270	\$1,122,795	\$1,140,944	\$1,159,384
R&R Fund	<u>\$17,005</u>	<u>\$139,750</u>	<u>\$144,501</u>	<u>\$148,975</u>	<u>\$153,438</u>	<u>\$158,048</u>	<u>\$162,694</u>	<u>\$165,641</u>	<u>\$168,419</u>	<u>\$171,142</u>	<u>\$173,908</u>
Net Funds for DS	\$436,452	\$3,586,906	\$3,708,857	\$3,823,701	\$3,938,249	\$4,056,561	\$4,175,811	\$4,251,440	\$4,322,762	\$4,392,634	\$4,463,629
PV Sr Debt @ 4.00%	\$79,186,645										
<u>Subordinated Debt</u>											
Funds for DS	\$130,369	\$1,071,414	\$1,107,841	\$1,142,144	\$1,176,360	\$1,211,700	\$1,247,320	\$1,269,911	\$1,291,214	\$1,312,085	\$1,333,292
DSC	\$6,518	\$53,571	\$55,392	\$57,107	\$58,818	\$60,585	\$62,366	\$63,496	\$64,561	\$65,604	\$66,665
R&R Fund	\$5,215	\$42,857	\$44,314	\$45,686	\$47,054	\$48,468	\$49,893	\$50,796	\$51,649	\$52,483	\$53,332
Net Funds for DS	\$118,636	\$974,986	\$1,008,135	\$1,039,351	\$1,070,488	\$1,102,647	\$1,135,061	\$1,155,619	\$1,175,005	\$1,193,998	\$1,213,296
PV Sub Debt @ 4.00%	\$21,524,370										
Total Value	\$100,710,000										
	<u>2030</u>	<u>2031</u>	<u>2032</u>	<u>2033</u>	<u>2034</u>	<u>2035</u>	<u>2036</u>	<u>2037</u>	<u>2038</u>	<u>2039</u>	<u>2040</u>
<u>Senior Debt</u>											
Funds for DS	\$5,889,994	\$5,985,175	\$6,083,778	\$6,175,035	\$6,267,660	\$6,361,675	\$6,457,100	\$6,553,957	\$6,652,266	\$6,752,050	\$6,853,331
DSC	\$1,177,999	\$1,197,035	\$1,216,756	\$1,235,007	\$1,253,532	\$1,272,335	\$1,291,420	\$1,310,791	\$1,330,453	\$1,350,410	\$1,370,666
R&R Fund	\$176,700	\$179,555	\$182,513	\$185,251	\$188,030	\$190,850	\$193,713	\$196,619	\$199,568	\$202,562	\$205,600
Net Funds for DS	\$4,535,295	\$4,608,585	\$4,684,509	\$4,754,777	\$4,826,098	\$4,898,490	\$4,971,967	\$5,046,547	\$5,122,245	\$5,199,079	\$5,277,065
<u>Subordinated Debt</u>											
Funds for DS	\$1,354,699	\$1,376,590	\$1,399,269	\$1,420,258	\$1,441,562	\$1,463,185	\$1,485,133	\$1,507,410	\$1,530,021	\$1,552,972	\$1,576,266
DSC	\$67,735	\$68,830	\$69,963	\$71,013	\$72,078	\$73,159	\$74,257	\$75,371	\$76,501	\$77,649	\$78,813
R&R Fund	\$54,188	\$55,064	\$55,971	\$56,810	\$57,662	\$58,527	\$59,405	\$60,296	\$61,201	\$62,119	\$63,051
Net Funds for DS	\$1,232,776	\$1,252,697	\$1,273,335	\$1,292,435	\$1,311,821	\$1,331,499	\$1,351,471	\$1,371,743	\$1,392,319	\$1,413,204	\$1,434,402
	<u>2041</u>	<u>2042</u>	<u>2043</u>	<u>2044</u>	<u>2045</u>	<u>2046</u>	<u>2047</u>	<u>2048</u>	<u>2049</u>	<u>2050</u>	
<u>Senior Debt</u>											
Funds for DS	\$6,956,131	\$7,060,473	\$7,166,380	\$7,273,876	\$7,382,984	\$7,493,728	\$7,606,134	\$7,720,226	\$7,836,030	\$7,953,570	
DSC	\$1,391,226	\$1,412,095	\$1,433,276	\$1,454,775	\$1,476,597	\$1,498,746	\$1,521,227	\$1,544,045	\$1,567,206	\$1,590,714	
R&R Fund	\$208,684	\$211,814	\$214,991	\$218,216	\$221,490	\$224,812	\$228,184	\$231,607	\$235,081	\$238,607	
Net Funds for DS	\$5,356,221	\$5,436,564	\$5,518,113	\$5,600,884	\$5,684,897	\$5,770,171	\$5,856,723	\$5,944,574	\$6,033,743	\$6,124,249	
<u>Subordinated Debt</u>											
Funds for DS	\$1,599,910	\$1,623,909	\$1,648,267	\$1,672,991	\$1,698,086	\$1,723,558	\$1,749,411	\$1,775,652	\$1,802,287	\$1,829,321	
DSC	\$79,996	\$81,195	\$82,413	\$83,650	\$84,904	\$86,178	\$87,471	\$88,783	\$90,114	\$91,466	
R&R Fund	\$63,996	\$64,956	\$65,931	\$66,920	\$67,923	\$68,942	\$69,976	\$71,026	\$72,091	\$73,173	
Net Funds for DS	\$1,455,918	\$1,477,757	\$1,499,923	\$1,522,422	\$1,545,258	\$1,568,437	\$1,591,964	\$1,615,843	\$1,640,081	\$1,664,682	