ESOPs 101
Understanding the Basics of Employee Stock Ownership Plans

February 18, 2003
Outline

- Benefits/Considerations to an ESOP Transaction
- Uses of an ESOP
- Valuation Issues
  - Valuation Standard
  - Regulatory Authority
  - Valuation Methods
  - Premiums and Discounts
  - Potential Valuation Problems
Outline

- Advanced Valuation Issues
  - Accounting for an ESOP
  - Post Transaction Value
  - ESOP Tax Shield
  - Sub S ESOP Valuations
  - Repurchase Obligation
Valuation Standard
Valuation Standard

- **Fair Market Value**
  - “The price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties having reasonable knowledge of relevant facts.”

- Hypothetical standard
- Emotion or need are not factors
- Reasonable knowledge is important
- Define what you are valuing
Valuation Standard

- Adequate Consideration Rule - two part test (the ESOP can purchase for no more than adequate consideration or sell for no less than adequate consideration.)
  - Fair market value - similar definition as Revenue Ruling 59-60
  - Good Faith determination made by trustee - objective standard of conduct
    - Apply sound business principals of valuation and conduct a prudent investigation of circumstances.
    - Independence or use of an appraiser who is independent.
Regulatory Authority
Regulatory Authority

- Revenue Ruling 59-60
  - Look at all material factors (qualitative or quantitative)
  - Informed judgement and reasonableness
- DOL Proposed Regulations (gives a list of factor to consider)
- Thorough due diligence process is critical
  - Obtain and provide appraiser good and complete information
  - Read, question and discuss valuation with appraiser
Requirements of an ESOP Appraisal

- Must be in writing
- Provided by a qualified and independent appraiser
  - The appraiser is a professional advisor to the ESOP and the trustee regardless of who pays the fee.
- Must be provided, at least, on an annual basis.
  - Or whenever there is a transaction with a prohibited party (such as a control shareholder) or the ESOP is selling out.
Requirements of an ESOP Appraisal

- Required Content in the ESOP valuation report.
  - DOL proposed regulations on “Adequate Consideration” identify specific information that the report “must contain, at a minimum.”
    - Summary of qualifications of appraiser
    - Statement of assets values and methods used in determining value
    - Full description of the asset
    - Factors taken into account in making the valuation
    - Purpose of the valuation
    - Relevance accorded to the valuation methods used
    - Effective date of the valuation
    - Signature of the appraiser and date report signed
Requirements of an ESOP Appraisal

Required Content in the ESOP Valuation Report

- The regulations also provide that the report “must include in addition to an assessment of all other relevant factors,” an assessment of the below factors:
  - Nature of business and history of enterprise
  - General economic outlook and specific industry outlook
  - Book value and financial condition of company
  - Earning capacity of company
  - Dividend-paying capacity of company
  - Whether or not there is any goodwill or intangible value
  - Market price of similar publicly traded securities
  - Lack of marketability of securities
  - Whether a control premium is warranted (third party standard)
Valuation Methods
Valuation Methodologies

- All business valuation methodologies appropriate for use in ESOP valuations can be classified under one of three basic approaches to value:
  - Market Based Approaches
  - Income Based Approaches
  - Asset Based Approaches
Valuation Methodologies

- Guideline Companies Method - Market Based
  - The guideline companies methodology is used to estimate a company’s equity value by applying market related pricing ratios of publicly traded stocks to the performance of subject company.
  - RR 59-60 requires its consideration.
  - Key Value Drivers:
    - Historical company performance
    - Public company multiples
    - Relative risk
    - Relative growth prospects
Valuation Methodologies

- Merger & Acquisition Methodology - Market Based
  - Based upon transactions involving the transfer of control of a corporation. Involves the application of multiples similar to the guideline companies analysis. However, often has limited usefulness due to small number of mergers and acquisitions with detailed public information.
  - Important to consider in control ESOP transactions.
  - Key Value Drivers:
    - Transaction multiples
    - Credit markets
Valuation Methodologies

- Discounted Cash Flow Analysis - Income Based
  - The discounted cash flow methodology relies on estimates of the future profitability and performance of the Company. Future unleveraged operating cash flows are discounted back to their present value using a market related discount rate.
  - Both IRS and DOL have supported its relevance in ESOP valuations, and have declared it the preferred method in an increasing number of cases.
  - Key Value Drivers:
    - projected future cash flows
    - required capital investments
    - discount rate
    - sustainable long term growth rate
Valuation Methodologies

- Capitalized Cash Flow - Income Based
  - The capitalized cash flow method relies on the analysts determination of a normalized level of sustainable cash flow for the company, taking into account required future investments in capital. This normalized level of cash flow is then capitalized at a market related capitalization rate.
  - Useful when forecasts are not deemed reliable or business is extremely cyclical.
  - Key Value Drivers:
    - Normalized cash flows
    - Required Capital Investments
    - Capitalization rate (related to discount rate)
    - Sustainable growth rate
Valuation Methodologies

- Net Asset Value Methodology - Cost Based
  - The Net Asset Value Methodology “marks-to-market” all balance sheet assets and liabilities to determine value. This method is most applicable to holding companies.
  - Key Value Drivers:
    - Market value of assets
    - Market value of liabilities
Valuation Methodologies

- Asset Liquidation Methodology - Cost Basis
  - In addition to marking-to-market all assets and liabilities, the asset liquidation methods assumes an orderly liquidation of assets and factors in the cost of this liquidation as well as the time value and tax consequences.
  - Questionable relevance in minority ownership situations.
  - In conflict with the ESOP “going-concern” premise of value, but may be appropriate during temporary market declines.
  - Key Value Drivers:
    - Market Value of Assets
    - Market Value of Liabilities
    - Liquidation timing and costs
Premiums and Discounts
Relative Levels of Value

Total Firm Value (Controlling Shareholder)

Premium for Control  Minority Interest Discount

Marketable Minority Interest Value
Price Quoted in the Wall Street Journal or Over the Counter

Discount for Lack of Marketability

Non-marketable Minority Interest Value
# Relative Levels of Value

<table>
<thead>
<tr>
<th></th>
<th>Control Value</th>
<th>Control Value</th>
<th>Minority Value</th>
<th>Minority Value</th>
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<tr>
<td></td>
<td>ESOP</td>
<td>Non-ESOP</td>
<td>ESOP</td>
<td>Non-ESOP</td>
</tr>
<tr>
<td>Firm Value (control)</td>
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<td>$10,000,000</td>
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<td>Less: Capital Debt</td>
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<td>Control Equity Value</td>
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<td>Less Minority Interest Discount</td>
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Control Premiums in ESOP Valuations

• When should the ESOP pay control?
  – The DOL suggests ESOP should pay a control premium only to the extent that a third party would also pay such a premium.
  – In addition, the ESOP must receive voting control in fact.
  – DOL is highly scrutinizing 2-stage control transactions.
Control Premiums in ESOP Valuations

• Since the participant shares are minority interests, should they always be valued as minority interests?
  – The ESOP shares held by the trust are treated as a single block and the appropriate premise of value (control or minority) should be applied.
Marketability Discounts for Non-ESOP Shares

• Minority blocks of non-ESOP stock typically have marketability discounts in the 25% to 45% range.

• Control blocks of stock are generally more readily marketable than minority blocks with typical discounts in the 0% to 5% range.
Marketability Discounts

- A greater or lesser discount is permitted on the basis of the impact of factors such as:
  - Restrictions on transfer
  - A buy-sell agreement
  - The proposal of a public offering or sale of the company
  - A put option
  - The market available that may be interest in purchasing the shares
  - Dividends or partnership pay-outs.
Marketability Discounts for ESOP Shares

- The impact of ESOP put rights

- In assessing the marketability discount for ESOP shares, both the put right and the capacity of the company to honor such put rights should be considered.

- Repurchase liability and its impact on liquidity

- Diversification requirements

- Marketability discounts for ESOP shares typically range from 0% to 15%.
Potential Valuation Problems
Potential Valuation Problems

- Failing to obtain adequate background information on the company, the industry, and the economic environment in which the company operates.
- Valuing the company solely on the basis of its financial statements.
- Using financial statements for a shorter period of time than would represent a normal business cycle.
- Failing to consider the company’s working capital position.
Potential Valuation Problems

- Ignoring the existence of intangible assets or other off-balance sheet value.
- Failing to adjust income statements to arrive at true earning capacity.
- Basing a valuation on a single method without considering other methods.
- Using incorrect methods given the facts and circumstances.
- Disregarding prior arm’s length sales of the company’s stock.
Potential Valuation Problems

- Failure to consider trading prices of public companies in the same or similar business.
- Capitalizing an earnings base that arbitrarily ignores loss years.
- Failure to apply a minority interest discount or control premium when appropriate.
- Incorrect application of a discount for lack of marketability in relation to the terms of the “put” provision.
Federal Challenges to ESOP Valuations

- Do-it-yourself valuations in which the corporation or one of its employees determines the value of the corporate stock.
- Use of the corporation’s regular accounting firm, which often lacks the necessary independence.
- Having the valuation done by a person or firm not thoroughly experienced in ESOP valuations.
- Use of unconventional valuation methods that are not acceptable to the IRS and DOL.
Federal Challenges to ESOP Valuations

- Failure to adequately document the valuation analysis.
- Basing an ESOP transaction on a valuation that is out of date at the time of the transaction.