A New Approach to Outside Offers

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Editor's Note: With this article, we continue to explore an often surprising event in the life of an ESOP company - an offer to purchase the firm.

The board of directors of a successful company is knowledgeable about how to run that company -- how to hire competent executives, how to set overall policies that will help the company to prosper and grow, how to evaluate the investment of profits. Offers to purchase, however, are unusual events in the experience of most board members. An outside purchase of an ESOP company might even harm the employee-owners more than it helps them, by eliminating their jobs and all the benefits they receive from employment. There are almost no ESOPs where individual employees own enough stock to compensate them for five years of wages, yet loss of employment might well entail such a cost, or more, to the laid-off employee, who might face some months without work, the loss of benefits including life and health insurance, the costs of a job search, and the expense of relocation.

Despite all these potential negatives, the ESOP trustee is bound by law to consider the interests of the employee owners only as participants in the plan and not as employees per se. But an offer to buy the stock of an employee-owned company is not like an offer to buy the publicly-traded stock of a large company that is held in a retirement fund. A fund trustee can easily accept a good offer on a block of stock and then buy another promising stock that will grow and benefit the participants. The total value to the employee owners of an ESOP that is sold cannot be easily replaced. Many professionals use a rough rule of thumb for considering offers to purchase: an offer can be rejected if it is less than 20% more than the stock valuation, and an offer 20% above the ESOP stock value should be accepted.

Beyond the rough rule, however, boards and ESOP trustees need analytic tools to make the best possible decision within the law. Bill McIntyre presents a way to analyze an offer based on the value of the company to the prospective buyer. This approach gets closer to the perspective of the employee owner -- what is the benefit s/he will derive from the company in the future, the benefit that the buyer hopes to receive if the offer is successful?

Being an ESOP trustee can be challenging, and one of the most challenging times is when another company makes an offer to purchase the ESOP stock at a price considerably higher than the stock price set at the last ESOP valuation. While an ESOP trustee is not required to accept such an offer, the trustee is a fiduciary who is required to act solely for the benefit of Plan participants (and not for the employees, even though they may be exactly the same people). From that perspective, it is often very difficult to justify rejecting an offer that is more than 20% above the current ESOP stock price, even though some of the employees may lose their jobs and all the benefits that go with it.

I offer here an alternate approach for ESOP trustees to consider outside offers for ESOP stock. This approach would provide more flexibility for ESOP trustees without requiring any change in law or regulations, and it might allow the rejection of many offers that seem at first glance to be "an offer the trustee can't refuse," but upon further review, are offers that can easily be refused. This will make it easier for ESOP companies that want to remain ESOPs to do so.

As an example, let's consider ABC Company, a 100% ESOP-owned company, with a current ESOP stock price of $10 per share. ABC ESOP participants and employees want to remain an ESOP "forever." However, XYZ Company, a competitor, makes a bona fide offer of $14 per share to ABC's ESOP trustee committee.

The trustees are aware that ABC's people want to remain an ESOP, but they don't know how they can reject the offer without violating their fiduciary responsibility to Plan participants.

Further, the trustees realize that XYZ will terminate many of ABC's employees if it purchases ABC. At a minimum, the trustees estimate that XYZ will lay off 80% of the sales and marketing department as it already has sales representatives in the area; 75% of the accounting and finance department, including the CFO, as it already has people performing those functions; and the CEO, as it doesn't need two CEOs.

This is not a fun decision for the trustees. Unfortunately, unless the company is a certified "B" or benefit corporation (There will be more on B or benefit corporations in the next issue of *Owners at Work*.), they cannot take into account what will happen to ABC's employees. They can only consider that ABC's ESOP participants will collect a "bonanza" by selling their stock to XYZ at $14 per share.

Nevertheless, I would recommend that the trustees perform some additional calculations in their analysis of the offer.

Trustees: Determine the Value of Your Company to the Acquiring Company

The trustees should calculate what the stock price of ABC would be for XYZ assuming that XYZ implemented all of the cost-saving actions identified by the trustees. They would likely need the assistance of their valuation advisor to perform this analysis.

Let's assume that there are 1,020,000 shares of ABC ESOP stock and the following income statement for ABC Company by itself and after the sale to XYZ (numbers are in thousands):

	ABC Alone	ABC After Sale to XYZ
Sales Revenue	**$10,000**	**$10,000**
Less: Cost of Goods Sold		
Materials	3,700	3,700
Labor	1,200	1,200
Depreciation	500	500
Overhead	1,000	1,000
Subtotal COGS	**6,400**	**6,400**
Gross Profit	**3,600**	**3,600**
Less Operating Expenses		
Engineering/R&D	500	500
Sales/Marketing*	700	140
Accounting & Finance^	600	150
HR & Admin.	400	400
Depreciation	300	300
Executive±	200	-0-
Subtotal	**2,700**	**1,490**
Profit Before Tax	**900**	**2,110**

*80% eliminated
^75% eliminated
±Eliminated by XYZ

EBITDA is a popular figure to use in determining the value of a company. It stands for Earnings Before Interest, Taxes, Depreciation, and Amortization. It approximates cash flow generated by operating the company. Valuation advisors analyze the current market, then determine a proper multiple of EBITDA to estimate the value of a company. In this example, I'll use six, a commonly used multiple.

EBITDA of ABC Alone = $900,000 Profit Before Tax + $800,000 Depreciation = $1,700,000.

EBITDA of ABC after sale to XYZ = $2,110,000 Profit Before Tax + $800,000 Depreciation = $2,910,000.

Using the multiple of 6X EBITDA, ABC Company's total value is $1,700,000 X 6 = $10,200,000. Dividing by the 1,020,000 ESOP shares of stock, that gets to ABC's valuator's stock price per share = $10.00.

Because of its cost savings, the value of ABC Company to XYZ is $2,910,000 X 6 = $17,460,000. Dividing by the 1,020,000 shares owned by the ESOP, the value of ABC (to XYZ) is $17.12 per share.

	ABC Alone	ABC After Sale to XYZ
EBITDA	1,700	2,910
Multiply by	x6	x6
Value of ABC	10,200	17,460
÷ # of Shares	÷1,020	÷1,020
ESOP Stock Price per Share	**$10.00**	**$17.12**

But XYZ offered only $14.00 per share.

Valuation is an approximation, and things don't have the same value to different purchasers. The valuator estimated the ESOP stock value of ABC Company as a stand-alone enterprise. My alternative valuation estimates the value of the company to XYZ after it makes some planned changes.

The offer of $14.00 per share doesn't look quite so exciting any more. A fair price for XYZ to pay would be $17.12 per share, and its offer of $14.00 per share is inadequate. It can safely be rejected by the ESOP trustees.

The approach described here seems like an excellent approach for ESOP companies and trustees to use when considering whether or not to accept an offer that exceeds the current ESOP stock price, but I have not heard of anyone actually using it, even though it should allow ESOPs that want to remain employee-owned to be able to do so.

Comments on the appropriateness, practicality or legality of this approach are very welcome. OAW