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presents

Employee Stock Ownership Plans: Key Valuation Decisions

Practical Solutions for ESOP Marketability Discounts, Loans and Other Valuation Challenges

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

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Wednesday, February 24, 2010

The conference begins at:

1 pm Eastern

12 pm Central

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Employee Stock Ownership Plans: Key Valuation Decisions Webinar

Feb. 24, 2010

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Today's Program

- Relevant Valuation Guidelines, slides 3 through 5

- Challenging ESOP Valuation Issues, slides 6 through 32

Relevant Valuation Guidance

Legal And Other Guidance

- IRS (IRC §409, IRC §4975, Rev. Rul. 59-60, etc.)
- ERISA (§408(e) etc.)
- U.S. Department of Labor proposed regulation on adequate consideration and other rulings
- Numerous court decisions
- Valuation credentialing organization standards
- Uniform Standards of Professional Appraisal Practice (USPAP)
- ESOP advocacy associations
- Educators and researchers
- Practitioner opinions, treatises, white papers

Concepts To Bear In Mind

- Sale of company stock to an ESOP
- Sale price cannot exceed "adequate consideration," i.e. fair market value, as the ESOP trustee or a named fiduciary of the ESOP determines (see ERISA §3(18)(B), DOL Proposed Reg. §2510.3-18, Rev. Rul. 59-60).
- An independent appraiser must be used in determining fair market value (see IRC §401(a)(28)).
- The ESOP trustee or named fiduciary is the decision-maker; the independent appraiser is merely an adviser.
- Valuation can involve a range rather than a specific price (see preamble to DOL proposed regulation).
- Fair market value must be determined as of the date of the transaction. The use of "stale" values is impermissible (see DOL Proposed Reg. §2510.3-18(b)(2)(ii)).
- Post-transaction valuations must be conducted at least annually (see, e.g., Treasury Reg. §54.4975-11(d)(5)).

Challenging ESOP Valuation Issues

Valuation Issues Summarized

- Discount for lack of marketability (DLOM)
- Other types of discounts
- Leveraged vs. non-leveraged ESOPs
- Difference between ESOP installation value and annual update value
- Income vs. market approaches to valuation
- Second-stage transactions and control premiums
- Impact of repurchase liability on valuation
- Selling companies that have ESOPs
- ESOPs with preferred stock
- Statement of Auditing Standards (SAS) 101 reviews

Lack of Marketability Discounts

- The ability to trade stock quickly is valuable to investors.
- The stock of privately-owned companies is not readily tradable; thus, a discount for lack of marketability (DLOM) is often assessed.
- However, company stock that an ESOP participant receives upon termination of employment generally has a “put” right. See Code §409(h).
  - The employer is required to repurchase such company stock.
- The put right, by creating a market for the stock, decreases the DLOM.
  - Typical DLOM is 5% to 15% (vs. 35% non-ESOP).
- The appraiser and the ESOP trustee or named fiduciary must consider the enforceability of the put and the prospects of the employer being able to meet its obligations under the put.
- What about impact of liquidity in the ESOP trust?

Other Discounts

- Dependent on a key customer
- Dependent on a key supplier
- Dependence on a key employee or two
  - How is this addressed, since comparable companies to which the appraiser looks for indications of value may not have such dependence?
  - Market approach vs. income approach
- Lease/facility/relocation risks
- Macroeconomic risk (should there be another discount due to this risk?)
- Other FOLEIM risks? (financial, operational, legal, economic, industry, market)

Leveraged Vs. Non-Leveraged ESOPs

- When an owner sells stock to an ESOP via a leveraged transaction, how is the ESOP debt treated when valuing the company post-transaction?
  - Nearly all appraisers reduce the value of the company by the amount of the ESOP loan.
- Payouts to terminated ESOP participants generally do not occur during the ESOP loan period, so, as and when the ESOP loan is paid off, the company value returns to pre-leveraged levels. (death/disability/retirement as exceptions).
- Does operating debt (non-ESOP debt) affect value?
- How is the company's operating debt treated, for valuation purposes?
- Does it make sense to treat each differently?
- How should debt on sale to ESOP of second tranche of stock be treated?

Leveraged Vs. Non-Leveraged ESOPs (Cont.)

- Floor price protection (FPP)
  - Some leveraged ESOP transactions are established with a "floor" price on previously acquired shares of stock sold to the ESOP, meaning the value of those shares will be protected from the newly incurred debt.

- Company impact
  - Will this hurt growth?
  - Does this affect value?
  - Is this a good idea or a bad idea?

Leveraged Vs. Non-Leveraged ESOPs (Cont.)

- Factors to consider (for FPP):
  - What should the floor price be?
  - Should it be fixed or variable?
  - How long to keep in place?

- The IRS has ruled that with an S corporation ESOP, the floor price does not create a second class of stock, which an S corporation generally cannot have.

Valuation At Time Of Transaction Vs. Annual Updates

- DOL regulations require that fair market value must be determined as of the date of the ESOP transaction (see DOL proposed Reg. §2510.3-18(b)(2)(ii)).
- Appraisers typically value company stock as of the last day of the plan year, for purposes of ESOP administration.
- Does this mean the year-end value is of no use in connection with an ESOP's purchase (or sale) of company stock during the following year?
- Appraisers often update the year-end valuation and provide a "bring-down letter," rather than perform a full-blown valuation as of the date of the ESOP transaction.

Valuation At Time Of Transaction Vs. Annual Updates (Cont.)

- Appraisers and the ESOP trustee or named fiduciary are less comfortable with relying on an update the longer into the year the ESOP transaction is to occur.
- How far into a year can a transaction occur without having to perform a full-blown valuation?
  - 90 days?
  - Longer?
- As a rule of thumb, if the ESOP transaction occurs more than 90 days after the end of the year, the ESOP trustee or named fiduciary is apt to insist upon a full-blown appraisal.
- A significant change in economic climate, financial performance or industry conditions may warrant a comprehensive valuation, no matter when the ESOP transaction is to occur.

Use Of Income Vs. Market Approaches To Valuation

- There are a number of valuation methodologies the appraiser uses
  - Income approach
    - Capitalization of earnings
    - Capitalization of cash flow
    - Discounted cash flow (DCF)
    - Discounted future net income
  - Market approach
    - Guideline private company (merged and acquired)
    - Guideline public company
- For example, in the guideline public company method, the appraiser values the ESOP company by comparing it to the values of similar public companies.

Use Of Income Vs. Market Approaches To Valuation (Cont.)

- Compare the public company stock price to various financial indicators, such as price-to-earnings (P/E), revenue, earnings before interest and taxes (EBIT), and earnings before interest, taxes, depreciation and amortization (EBITDA).

- Apply the multiples to the financial indicators of the company whose stock is the subject of the ESOP transaction.

- In today's volatile financial markets, is the price of a public company's stock on any given day a reliable indicator that the appraiser can use, e.g. the guideline company method?

- Are the financial markets too volatile for use?

Second-Stage Transactions And Control Premiums

- Control premiums are a hotly debated subject.
- Buyers generally will pay more for control of a company and the benefits inherent in being able to manage operations.
- The DOL acknowledges the validity of an ESOP paying a control premium for employer stock it purchases (see proposed DOL Reg. §2510.3-18(b)(4)(ii)(I)).
  - The proposed regulation focuses on:
    - Whether the seller would be able to obtain a control premium from an unrelated third party,
    - Whether actual control – in form and substance – is passed to the ESOP with the sale or will be passed to the ESOP within a reasonable time pursuant to the binding agreement in effect at the time of sale, and
    - Whether it is reasonable to assume that the ESOP's control will not be dissipated within a short period of time subsequent to the ESOP's purchase.

Second-Stage Transactions And Control Premiums (Cont.)

- Typical scenario
  - Initial sale to ESOP is for 30% ownership interest. The block of stock sold is non-controlling; therefore, the ESOP does not pay for control (no control premium in price).
  - Subsequent sale to ESOP is for an additional 30%. While the second 30% block is also a non-controlling block on its own, it pushes the ESOP ownership to 60%.
  - Does the second sale permit the ESOP to pay a control premium?
- The consensus in the appraisal community is that if the ESOP pays a control premium, ESOP participants who receive employer stock from the ESOP following termination of employment and put such stock to the employer should receive a control premium price for such shares, even though such shares are a small minority of the employer's stock.
  - One federal court has ruled, or at least implied, that in this situation it would be proper not to pay the former participant a control premium.

Second-Stage Transactions And Control Premiums (Cont.)

- Many appraisers may not "bless" a transaction involving the payment by the ESOP of a control premium where the ESOP does not acquire control at the time of the sale to the ESOP, even though the ESOP has a contractual right to buy more stock of the employer in the next few years so as to purchase a controlling interest in the employer.
- Factors that may or may not influence this decision:
  - Existence of a binding agreement granting the ESOP the right to acquire a controlling position,
  - Anticipated length of time before the ESOP can acquire a controlling position,
  - The financial ability to fund the ESOP's acquisition of a controlling position, and
  - The rights inuring (or not inuring) to the ESOP upon acquisition of a controlling position.

Impact Of Repurchase Liability On Valuations

- The statute and regulations require that an ESOP participant who terminates employment and receives a distribution of stock from the ESOP has the right to sell, i.e. “put,” the stock back to the employer.
- The employer’s obligation to repurchase the stock is referred to as “repurchase liability.”
- There are volumes spoken and written on this subject.
- The repurchase obligation of the employer affects the value of the employer and its stock.
- If the ESOP borrowed money to buy employer stock, the ESOP documents can and often do prohibit repurchases of employer stock until the ESOP debt is retired.
  - <u>Exceptions</u>: Participants who terminate employment after normal retirement age or on account of disability or die; they (or their estates) can put their stock they receive from the ESOP back to the employer even though the ESOP debt is not retired.

Impact Of Repurchase Liability On Valuations (Cont.)

- Repurchase liability is affected by a number of factors
  - ESOP ownership percentage relative to total ownership
  - ESOP plan specifics (distribution rules, eligibility requirements, vesting schedule)
  - Other purchase obligations (buy-sell agreements)
  - Method of handling the repurchase liability
  - Company labor pool demographics and actuarial statistics
  - Financial performance variables (growth , profitability, funding vehicle(s))
- Methods of handling repurchase liability
  - Redemption by company
  - Recycle in ESOP
  - ESOP investment

Impact Of Repurchase Liability On Valuations (Cont.)

- Redemption by company
  - Capital transaction (balance sheet impact only)
  - No impact on per-share value but reduces total equity value
  - No income tax benefits
- Recycling
  - Expense/contribution transaction (income statement impact only)
  - Cash is contributed to the ESOP for purchasing stock from the terminated ESOP participants.
  - In the alternative, the company purchases stock from the terminated ESOP participants and contributes it to the ESOP.
  - Either technique creates a tax deduction for the company.
  - Shares of such stock are allocated to remaining ESOP participants based on compensation.
- ESOP investing
  - Capital transaction
  - Shares purchased by the ESOP from terminated ESOP participants using cash balances in ESOP trust
  - No tax deduction
  - Shares allocated to remaining ESOP participants based on their proportionate stock balances in the ESOP

Impact Of Repurchase Liability On Valuations (Cont.)

- There is no consensus on how to handle impact on valuation of repurchase liability.
- The ESOP Association Valuation Committee is working on providing practical guidance.
- Ways in which repurchase liability may affect company or stock value:
  - Reduction in operating value,
  - Reduction in working capital,
  - Reduction in number of shares outstanding, and
  - Adjustments to valuation inputs (discount rate, DLOM, growth rate, future cash flows, market approach multiples, etc.)

Impact Of Repurchase Liability On Valuations (Cont.)

- Statement of Position 93-6 governs much of the accounting treatments for ESOPs.

- Statement of Financial Accounting Standards (SFAS) 150 (now Accounting Standards Codification (ASC) 480, *Distinguishing Liabilities from Equity*) requires companies to record a liability for mandatorily redeemable shares; however, ESOP shares are not technically redeemable while held by the ESOP, so a repurchase liability is not recorded on the balance sheet.

- Nevertheless, the appraiser should consider the repurchase liability in the valuation.

Selling Companies That Have ESOPs

- Seller process
  - Receive an offer
  - Confirm offer is bona fide
  - Management notifies board of directors (only if offer is bona fide)
    - Proposed purchase price and terms are fair
    - Purchaser can afford to pay purchase price
  - Due diligence is performed
  - Further negotiation and documentation takes place
  - Closing occurs
  - Post-closing issues are addressed

Selling Companies That Have ESOPs (Cont.)

- Seller board considerations
  - Are there alternate buyers/should an auction process be run?
  - How are shareholders affected?
  - Who will serve as advisors (due diligence, fiduciary, financial, investment banking, legal, etc.) to the transaction?
  - Should an ESOP company set as a goal remaining “employee-owned” indefinitely?

Selling Companies That Have ESOPs (Cont.)

- Seller due diligence
  - What is the price?
  - Is the transaction consideration stock and/or cash?
  - Sale of stock or assets?
  - Impact on ESOP?
    - Which is better: Sell now or hold for the future?
    - Financial fairness
      - Absolute (is price > fair market value)?
      - Relative (does ESOP receive fair share compared to other seller participants)?
  - Can the buyer deliver on its promises?

ESOPs With Preferred Stock

- An ESOP may acquire and hold convertible preferred stock (<u>see</u> IRC §§4975(e)(7), 409(l)).

- This approach is often used when the employer's payroll is small, so that permissible compensation-based contributions are not large enough to service the ESOP's debt repayment obligation.

- The preferred stock must be non-callable (or the ESOP must have a reasonable opportunity to convert after the call), convertible at any time into common stock having the greatest voting power and greatest dividend rights, and convertible at a conversion price that (as of the date of the acquisition by the ESOP) is reasonable.

ESOPs With Preferred Stock (Cont.)

- Should the preferred stock be treated as common stock for valuation purposes?
- If not, how is the preferred stock to be valued?
  - Dividend rate on the convertible preferred stock
  - Call protection that restricts the right of the employer to call the convertible preferred stock
  - Comparison of the price of publicly traded convertible preferred stock with comparable characteristics
  - Liquidation preferences
- Does the appraiser need to follow the AICPA's Practice Aid Valuation of Privately-Held-Company Equity Securities Issued as Compensation, 2004?

SAS 101 Reviews

- The Employee Retirement Income Security Act (ERISA) of 1974 requires the administrator of an ESOP to file an annual report with the IRS on the form (5500) prescribed for such purpose (see ERISA § 104(a)(1)(A)).
- ERISA also requires that the ESOP's financial statements be audited in accordance with generally accepted auditing standards (see ERISA §103(a)(3)(A)).
- Statement of Auditing Standards 101 (SAS 101) establishes standards for auditing "fair value assessments" and related disclosure in financial statements. As a result, SAS 101 applies to financial statements issued by ESOPs that hold non-publicly traded employer securities.
- SAS 101 requires auditors to acquire sufficient information to enable them to have a "…reasonable assurance that fair value assessments and disclosures are in conformity with GAAP."

SAS 101 Reviews (Cont.)

- ESOP valuations are done based on the standard of "fair market value." Auditors have a different standard, defined as "fair value."
- "Fair value" is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" (see SFAS 157, replaced by ASC 820, *Fair Value Measurements*).
- As part of the SAS 101 review process, the auditing firm will ask for a copy of the valuation report. Should it be provided? Who should provide it? Will the auditor understand the difference in standards?
- See white paper on "*Recommended Procedure for ESOP Companies in Response to Auditors Request for ESOP Valuation Report*," published by the ESOP Association's Interdisciplinary Advisory Committee on Fiduciary Issues.

SAS 101 Reviews (Cont.)

- Recommended procedures
  - Requests for valuation report should be made in writing;
  - The trustee, or perhaps the appraiser, should release the report, not the employer;
  - Acknowledgement from the auditor regarding scope of the valuation, effective date, assumptions and limiting conditions, and indemnification provisions should be received; and
  - If possible, auditor questions should be channeled through a single party, perhaps the trustee or the appraiser.