RECENT DEVELOPMENTS IN ANNUAL VALUATIONS

ESOP MIDWEST REGIONAL CONFERENCE
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TED BECKER
Drinker Biddle & Reath LLP
191 North Wacker Drive,
Suite 3700
Chicago, IL 60606
312.569.1301
ted.becker@dbr.com

ARLENE ASHCRAFT
Columbia Financial Advisors, Inc.
720 SW Washington
Suite 650
Portland, OR 97205
503.222.0562
aashcraft@cfai.com

GLENN ELO
Lifetouch Employee Stock Ownership Trust Trustee
11000 Viking Drive, 400 West Eden Prairie, MN 55344
952.826.5540
gelo@lifetouch.com
The DOL Fiduciary Process Agreement

The DOL Fiduciary Process Agreement has been in effect since mid-last year. While it expressly relates only to ESOP transactions, it offers useful guidance for annual valuations. This presentation, moderated by an attorney who negotiated the Agreement with the DOL, will review some of the things an internal trustee and a valuation advisor have been doing in the annual valuation process in view of the DOL Fiduciary Process Agreement.
The DOL Fiduciary Process Agreement

- **What is it?**
The DOL Fiduciary Process Agreement

- Formally, binds only the DOL and GreatBanc Trust Company, **BUT**
- In a Press Release dated June 30, 2014, DOL Assistant Secretary of Labor for Employee Benefits Security Phyllis Borzi said, “[o]thers in the Industry would do well to take notice of the protections put in place by this agreement.”
The DOL Fiduciary Process Agreement

- How has the ESOP Community responded to the Fiduciary Process Agreement?

- The response has been positive. Major institutional trustees and valuation firms have adopted much of the process set forth in the Agreement in connection with ESOP transactions.
The DOL Fiduciary Process Agreement

- **Does the Fiduciary Process Agreement apply to Annual Valuations?**
- It applies only to transactions in which an ESOP is purchasing or selling employer securities that are not publicly traded.
- **However,** external and internal trustees and valuation advisors can opt to follow aspects of the process set forth in the Agreement in connection with annual valuations.
The DOL Fiduciary Process Agreement

- Which aspects of the Fiduciary Process Agreement can serve as guidance in Annual Valuations?
  - Selection of Valuation Advisor
  - Oversight of Valuation Advisor
  - Financial Statements
  - Projections
  - Fiduciary Review Process
Selection of Valuation Advisor

- The Trustee will hire a qualified valuation advisor, and will:
  - prudently investigate the valuation advisor's qualifications.
  - take reasonable steps to determine that the valuation advisor receives complete, accurate and current information necessary to value the employer securities.
  - prudently determine that its reliance on the valuation advisor's advice is reasonable before entering into any transaction in reliance on the advice.
Selection of Valuation Advisor

- The Trustee will not use a valuation advisor for a transaction that has previously performed work for or on behalf of:
  - the ESOP sponsor company
  - any counterparty to the ESOP involved in the transaction
  - any other entity that is structuring the transaction for any party other than the ESOP or its trustee.

- The Trustee will obtain written confirmation from the valuation advisor regarding the above.
Selection of Valuation Advisor

- The Trustee will prepare a written analysis of:
  - the reason for selecting the valuation advisor.
  - a list of the valuation advisors considered.
  - a discussion of the valuation advisors' qualifications.
  - a list of references checked and discussion of the references' views on the valuation advisors.
  - whether the valuation advisor was the subject of prior criminal or civil proceedings.
  - a full explanation of the bases for concluding that the Trustee’s selection was prudent.
Oversight of Valuation Advisor

- The valuation advisor or the Trustee will document the following items:
  - Identify the individuals responsible for providing any projections reflected in the valuation report and inquire:
    - Do they have any conflicts of interest in regard to the ESOP?
    - Do they serve as agents or employees of persons with such conflicts?
    - What is the nature of any such conflict?
    - How did the Trustee and the valuation advisor consider such conflicts in determining the value of employer securities?
Oversight of Valuation Advisor

- Document the reasonableness of the projections. At a minimum, compare projections to company’s five-year historical averages or medians and to information for guideline public companies’ (if exists) for the following metrics:
  - Return on assets
  - Return on equity
  - EBIT margins
  - EBITDA margins
  - Ratio of capital expenditures to sales
  - Revenue growth rate
  - Ratio of free cash flows (of the enterprise) to sales
Oversight of Valuation Advisor

- If it is determined that any of these metrics should be disregarded, document the calculations of the metric if possible and the basis for disregarding.
  - The use of additional metrics is not precluded as long as the appropriateness of those metrics is documented.
  - Explain in writing the bases for concluding that any comparable companies are actually comparable.
  - Explain (in significant detail) if discounts are applied to the selected multiples, and why.
Oversight of Valuation Advisor

- Document all material assumptions supporting the projections and why they are reasonable.
- Document any adjustments made to the projections.
- Document any adjustments to the company's historical or projected financial metrics.
- Document the basis for the weighting assigned to each valuation method.
- Consider the prospective repurchase obligation and its effect on value and the prudence of the stock purchase.
Oversight of Valuation Advisor

- **Document in writing:**
  - whether the ESOP sponsor will be able to service the transaction debt (including in the event that the sponsor fails to meet its projections).
  - whether the transaction is fair to the ESOP from a financial point of view.
  - whether the transaction is fair to the ESOP relative to all the other parties to the proposed transaction.
  - whether the terms of the transaction financing are market-based, commercially reasonable, and in the best interests of the ESOP.
  - the financial impact of the transaction on the ESOP sponsor.
Financial Statements

- The Trustee will request audited unqualified financial statements for the preceding five fiscal years.
- If unavailable, the Trustee will determine whether it is prudent to rely on unaudited or qualified financial statements.
- The Trustee will document the bases for its reasonable belief that it is prudent to rely on any unaudited or qualified financial statements:
  - Explain how it accounted for any risk posed by using qualified or unaudited statements.
  - Do not proceed if not prudent to rely on the financial statements used in the valuation report.
Fiduciary Review Process

- The Trustee agrees to:
  - Determine the prudence of relying on the ESOP sponsor's financial statements provided to the valuation advisor.
  - Critically assess the reasonableness of any projections (particularly management projections).
  - Document its bases for concluding that the information supplied to the valuation advisor was current, complete and accurate.
Documentation of Valuation Analysis

- The Trustee will document its analysis of any final valuation report, including the Trustee’s conclusions (and bases therefor) regarding the treatment of:
  - Marketability discounts
  - Minority interests and control premiums
  - Financial projections (reasonableness)
  - Analysis of the company's strengths and weaknesses
Documentation (cont.)

- Specific discount rates chosen
- Financial statement adjustments
- Internal consistency of the report
- Reliability and timeliness of the historical financial data considered
- Comparability of selected public companies
- Material assumptions
- Use of averages, medians and outliers
Documentation (cont.)

- Treatment of corporate debt
- Methodologies employed
- The company's ability to service the transaction debt
- The reasonably foreseeable risks of the transaction
- Any other material considerations or variables that could have a significant effect on the price of the employer securities
Areas of Focus: DOL Fiduciary Process Agreement in Annual Updates

- Appraiser Independence & Qualifications
- Vetting Forecast
- Adjustment—Historical Financials and Forecast Financials
- Documenting Process
Application of the DOL Fiduciary Process Agreement in Annual Updates

- Annual due diligence on valuation advisor’s qualifications, not just at initial engagement
- Involving the ESOP Trustee in document request to the company—if the ESOP Trustee believes that additional things should be requested, they are added to the list
- Encouraging ESOP Trustee to attend management interviews
Application of the DOL Fiduciary Process Agreement in annual updates (Continued)

- Documenting/ascertaining where in the valuation report a metric mentioned in the DOL Fiduciary Process Agreement is found
- If internal ESOP trustee is involved in producing the forecast, reasonableness checks done by another party at the plan sponsor company
Application of the DOL Fiduciary Process Agreement in annual updates (Continued)

- Adding to the valuation report tables to address Section D.2 of the DOL Fiduciary Process Agreement (the ratios)
- Ensuring appropriate documentation of appraisal review process
Questions?

Ted Becker  
Drinker Biddle & Reath LLP  
191 North Wacker Drive, Suite 3700  
Chicago, IL  60606  
312.569.1301  
ted.becker@dbr.com

Glenn Elo  
Lifetouch Employee Stock Ownership Trust Trustee  
11000 Viking Drive, 400 West  
Eden Prairie, MN 55344  
952.826.5540  
gelo@lifetouch.com

Arlene Ashcraft  
Columbia Financial Advisors, Inc.  
720 SW Washington  
Portland, OR  97205  
503.222.0562  
aashcraft@cfai.com
Theodore M. Becker

**Ted Becker** is a partner in the Drinker Biddle & Reath LLP law firm. He has a national practice with more than 25 years of experience in litigation and dispute resolution. He has represented companies that sponsor ESOPs and other benefit plans, their directors and officers, external and internal plan fiduciaries, administrators, investment advisors, and service providers in lawsuits and investigations by regulatory agencies. He represents clients along the entire dispute continuum, from litigation avoidance and pre-litigation planning through pre-trial motions, discovery, trial, and appeal. He practices before the U.S. Supreme Court, federal and state trial and appeals courts, and bankruptcy courts, as well as before administrative and regulatory agencies including the Department of Labor, and in arbitration, mediation, and alternative dispute resolution proceedings. He has successfully represented clients ranging from individuals and small companies to the largest financial institutions and multinationals. He earned his law degree with highest honors at Northwestern University, and was a fellow at Yale Law School, where he taught.
Glenn Elo is an internal trustee for the Lifetouch ESOP. As Director of Taxes, he is also involved with both income tax and ESOP administration matters at Lifetouch. Mr. Elo has presented on ESOP trustee matters for the NCEO and ESCA, “C to S” conversion issues for ESCA, and on various tax and ESOP issues at Lifetouch. He has over 30 years of experience in corporate tax and 15 years of experience in ESOP matters. Mr. Elo holds a BS in accounting from the University of Minnesota and is a Certified Public Accountant.

Lifetouch is 100% employee owned and was built on the school tradition of “Picture Day”. Lifetouch provides photography services for families, schools, and organizations.
Arlene Ashcraft CFA, ASA is a principal and shareholder at Columbia Financial Advisors, Inc. Arlene specializes in ESOP valuation and financial advisory services and appraisals for litigation support purposes. She is an accredited senior appraiser of the American Society of Appraisers designated in business valuation and holds a Chartered Financial Analyst designation. She is a current member of the ASA’s business valuation committee and President of the Portland, Oregon Chapter of the ASA. Arlene is a member of the ESOP Association’s Valuation Advisory Committee. Arlene also currently serves on the Board of Directors of DKS Associates, a 100% ESOP owned transportation planning and engineering firm, headquartered in Oakland, CA. She is a frequent speaker on the subjects of ESOP appraisal and financial advisory issues.
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