ESOPs – Continuing the Education Process

Internal Trustee Review and Valuation Process

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Who Reviews ESOP Valuations?

ESOP valuations are reviewed by numerous parties

- ESOP Trustee
- Department of Labor ("DOL")
- Internal Revenue Service ("IRS")
- Company and/or ESOP plan auditors
- Company board of directors and/or senior management
- Other Company stakeholders
  - Financing providers and investors
  - Insurance firms
Current State of Affairs

ESOP appraisals are increasingly under heightened scrutiny

- Trend of increased government (i.e. DOL) oversight
- Increased auditor review and incorporation of valuation indicators in financial statements
- Disclosure requirements
- Litigation

How can appraisal withstand scrutiny?

- Appraiser must be independent and competent
- Appraisal must include information to support conclusions
- Appraisal must follow generally accepted valuation, DOL and IRS methodologies
- Trustee must follow proper process in reviewing and approving draft valuation report prior to determined value
Getting Started – Definition of a Fiduciary

ERISA defines a “fiduciary” as any person who with respect to an employee benefit plan:

1. Exercises discretionary authority or control over the management of a plan;

2. exercises any authority or control over the management or disposition of plan assets;

3. renders investment advice for a fee or other compensation with respect to plan assets;

4. has any discretionary authority or responsibility regarding plan administration.
Plan fiduciaries will generally include:

- Trustee(s)
- Plan Administrator (as defined in plan)
- Administrative/Investment Committee members
- Investment Managers
- Persons who select/appoint other fiduciaries

Function supersedes title:

- Notwithstanding a person’s title, the performance of fiduciary activities will cause a person to be deemed a fiduciary under ERISA.
Basic Issues – Selecting a Financial Advisor

Financial Advisor is selected and engaged by Trustee

- Required to be independent
- No common control with a related party
- Trustee has right to terminate engagement
- Examine initial feasibility engagements

*Sierra Aluminum Settlement*: Independence issues can arise if Financial Advisor previously engaged by Company/Seller for other purposes (e.g. preliminary valuation for an exploratory committee)
Criteria for selecting Financial Advisor

- Professional affiliations and credentials
- Experience with ESOPs & fairness opinions
- Relevant industry experience
- Valuation methodologies applied
  - familiar with warrant structures
  - familiar with synthetic equity arrangements
- What staff will work on your engagement?
- How are valuation reports reviewed internally?
- ESOP Company references
- ESOP Professional references
Determining FMV of Company Stock

Required on annual basis
- plan may require more frequent valuations
- special situations (purchase, sale, redemption)

Interactive process
- Financial Advisor
- Company
- Additional experts (e.g. compensation advisor)

Participate in management interview
- Difficult when Trustee is also Officer

Transactions: increase scrutiny on FMV conclusions and other fiduciary actions
Confidentiality of Valuation Report

Trustee should protect the confidentiality of the Financial Advisor’s valuation report

Requests for report:

- ESOP participants
- Company’s auditor
- Insurance providers (typically D&O)
- Governmental agencies
- Third party buyer
- Selling shareholder in a transaction

Develop a consistent policy/practice for releasing the report
Repurchase Liability

• Repurchase liability is a company obligation
• Understand how repurchase liability is reflected in the valuation report
• Review repurchase liability in the greater context of ESOP sustainability
  • Sophisticated planning with other advisors
• What strategies are currently in place to address repurchase liability?
• Share price increases should reflect company’s actual performance
ESOP Company Governance Structure

Parties Responsible for Managing Corporate Governance

- Shareholders
- Board of Directors
- ESOP Trustee
- Officers/Management

Who Affects Value?
ESOP Company Structural Overview

ESOP PARTICIPANTS

SHAREHOLDERS

ESOP Trustee

Appoints

ELECTS

BOARD OF DIRECTORS

MANAGEMENT

Hires

EMPLOYEES

*Upon satisfying ESOP eligibility requirements

Represents

ESOP COMMITTEE

Appoints
Valuations in ESOP Transactions

• ESOPs cannot pay more than (or receive less than) adequate consideration (i.e., fair market value) for company stock

• ESOPs cannot pay a strategic price as a financial buyer.

• ESOPs cannot pay for benefits that they provide in a transaction (income tax savings in S-corps)

• Departing ESOP participants are entitled to receive fair market value for their ESOP stock

• Valuation and/or final purchase price determined by trustee with assistance from independent valuator

• Adequate consideration and fair market value are synonymous

• ESOP valuations and transactions can be scrutinized by the DOL (increasingly more, given the DOL’s current stance on ESOPs)
Annual ESOP Valuation Process

- ESOP shares must be valued annually, as of the plan year-end, in connection with the ongoing administration of the ESOP

- Due diligence document review

- Coordinate site visit with financial advisor

- Interview senior management

- Economic and industry research

- Market research and financial analysis value determination

- Trustee presentation

- Final report delivery
Valuation Considerations

• Factors considered in ESOP valuations
  • Historical and expected future performance & trends
  • Market multiples of comparable companies and transactions
  • Economic, industry, and company-specific factors

• Future cash flow is key driver of value
  • Must consider risk in realizing projected cash flow

• Valuation must be forward-looking
  • Must consider anticipated future performance
  • Must consider post-transaction changes (leverage or dilution)
Valuation Considerations

Analyze five year trends and include consideration for:

- Margin analysis
  - EBITDA margins
  - EBIT margins
  - Pre-tax and/or net income margins
  - Ratio of capital expenditures to sales

- Growth rates
  - Revenue
  - EBITDA and/or EBIT
  - Pre-tax and/or net income

- Return metrics
  - Return on assets
  - Return on invested capital
  - Return on equity

The same ratios should be developed for any guideline companies used
Additional Valuation Considerations

- Understand:
  - Quality of projections
  - Operations
  - Strategic initiatives
  - Customer concentration
  - Financial outlook
  - History of company
  - Offers to buy/sell
  - Board/Management composition and changes
  - Litigation
  - Banking relationship
  - Executive compensation
  - Adjustments for non-recurring items
  - Adjustments non-operating assets and non-operating liabilities
  - Properly quantifying dilutive effects of synthetic equity
    - SARs
    - Phantom Stock
    - Warrants
  - Repurchase obligation and funding strategy
Discounted cash flow ("DCF") analysis: determine the "Value" of a project, a Company’s Equity, or a specific asset using the concepts of time value of money.

- The DCF analysis is based on the theory that the current value of an investment is based on the expected receipt of future economic benefits
- Project future cash generated by the company
- Discount cash flows to the present at an appropriate discount rate
- Estimate the perpetuity value at the end of the projection period and determine the present value of the perpetuity value
- DCF analysis is able to capture company-specific assumptions, making it a very robust analysis

DCF analysis assumptions
- Incorporate management projections
- Use independent judgment
- Be consistent with industry outlook
- Make sure investment requirements are consistent with growth and margins
Income Approach

- Capitalization (“Cap”) analysis: determine the “Value” of a project, a Company’s Equity, or a specific asset using the concepts of time value of money.
  - Just like the DCF analysis, the capitalization method is based on the theory that the current value of an investment is based on the expected receipt of future economic benefits
  - Uses historical results to estimate future cash generated by the asset
  - Capitalization rate incorporates both a discount rate and a growth rate
  - Assumes specific growth rates into perpetuity

- The Capitalization Analysis
  - Is strong when company is stable
  - Is generally less susceptible to assumption shortfalls
  - Is the inverse of pricing multiples
Market Approach

• Selected public company analysis: determine valuation multiples based upon reported stock prices of comparable publicly traded companies.

  • Analysis of financial performance, qualitative characteristics and trading multiples of public companies similar to the subject company
  • No company will be exactly similar
  • Concentrate analysis on growth, margins, returns and risk
  • Size, trading liquidity, and analyst coverage will also have a significant impact on trading multiples

• Typical valuation multiples
  • Enterprise value / EBITDA
  • Enterprise value / EBIT
  • Enterprise value / revenues
  • Price per share / earnings per share (P/E)
  • Price per share / book equity value per share (“Price to Book”)
Market Approach (continued)

- Selected Transaction Analysis: determine valuation multiples based upon Enterprise sales of comparable companies.

  - The selected transaction analysis is based upon reports of actual sales of whole companies
  - Selected transaction analysis is similar to the selected public company analysis in its methodology
  - Analysis of financial performance, qualitative characteristics and trading multiples of change of control transactions (generally public companies) similar to the subject company
  - Similar to the selected public company analysis in its methodology

- Typical valuation multiples
  - Price per share / earnings per share (P/E)
  - Enterprise value / EBITDA
  - Enterprise value / EBIT
  - Enterprise value / revenues
Cost Approach

- Adjust the company’s GAAP based (cost) assets and liabilities to estimates of market value to arrive at value of company’s equity. Some concepts
  - Replacement cost
  - Value in use
  - Orderly liquidation value
  - Benjamin Graham

- Not a typical approach in most ESOP appraisals although may have applicability in certain settings
  - Asset intensive industries such as real estate, shipping, trucking, equipment rental, dealerships, etc.
  - Distressed situations where earnings are negative and/or negligible
  - A more common subset of an ESOP appraisal when a subject company has non-operating assets such as real estate not used in operations, insurance products, investments in other companies, etc. on the corporate balance sheet
Reconciliation With Prior Year’s Valuation

- Trustee and valuator should be able to reconcile the current valuation with past valuations

- Factors that impact changes in value:
  - Company performance
  - Company expectations
  - Company balance sheet (e.g., debt & cash levels)
  - Industry dynamics
  - Economic environment
  - Valuation multiples in the industry
  - Health of the M&A market
Questions on the Annual ESOP Valuation

- Are the same valuation approaches being applied as in previous valuation reports?

- Are the valuation methods being applied consistently?

- Is the current weighting/preference for one method vs. another similar to prior year reports?

- Are the same discounts/premiums being applied?
  - Company Size Discount
  - Minority Interest Discount/Controlling Interest Premium
  - Discount for Lack of Marketability

- If deviations have occurred, are the reasons sufficiently explained?

- “COULD YOU EXPLAIN THE ANALYSIS AND CONCLUSION TO FELLOW PARTICIPANT?”