Valuation Issues for Mature ESOP Companies

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Preface

- Please fill out a session evaluation form and drop it off at the table outside of this room
- Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs
- Take a moment to silence your cell phone
- Remember to get your CPE sheet stamped before and after each session for CPE credit

What is a Mature ESOP?

- 10+ years
- Large account balances
- Level of benefits above normal
- Fully allocated
- Large cash balances

Mature ESOP Concerns

- Company's financial position
- Annual per share value
  - Considering the impact of the repurchase obligation on the company's equity value
- ESOP share purchase requirements
- Sustaining the level of benefits for newer employees
- Incorporating a longer-term ESOP investment time horizon

What are the Valuation Issues of a Mature ESOP?

- Treatment of employee benefit plan expense
  - Treatment of ESOP stock acquisition debt
- Treatment of company interest bearing debt
- Effect of company’s capital structure
- Volatility of company’s earnings
- Liquidity to fund the Repurchase Obligation (“RO”)

Concern Considerations

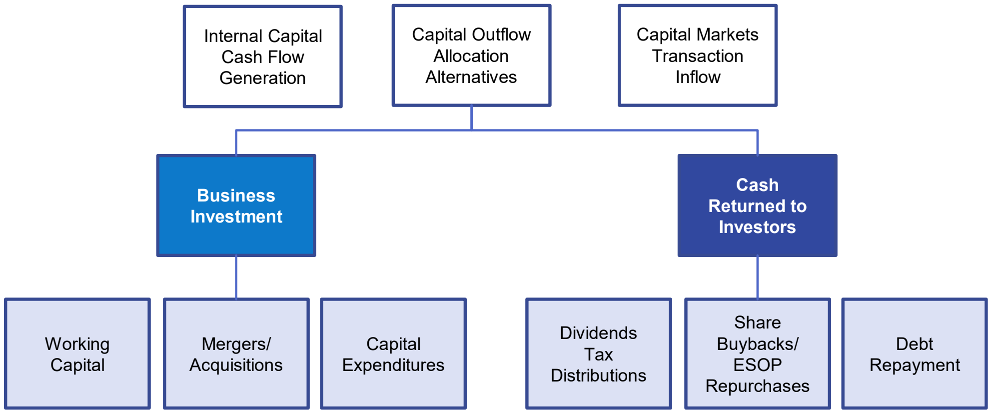
- A minority ESOP-owned company may become 100% ESOP
- Company may change from C to S corporation
- The size and value of vested plan assets may require a change in the way the sponsor company plans to fund its RO
- The sponsor company management may have to choose between funding a large RO and other investment opportunities:
  - Acquisitions
  - Investments in new PPE
  - Hiring new employees

Concern Considerations, cont.

- All these valuation issues have an impact on sponsor company projected cash flow
- These valuation issues should influence ESOP plan design and stock purchase transaction structure
- Valuation issues change in importance over time
- Valuation issues should always be considered in context of the fair market value of the employer company stock
- Consideration of these valuation issues should continue through the life cycle of the ESOP
  - May be appropriate to capture the RO in a specific line item within the company's historical and projected cash flow
  - Or an adjustment may be made in the valuation analysis, such as in the DLOM

Competition for Cash

- Executive management must judge the highest and best use of capital through a constant evaluation of the trade-off between investing in the business and returning cash to Shareholders



- Repurchase obligation represents a unique capital claim in an ESOP owned company relative to a non-ESOP owned company
- Statutory required funding obligation that cannot be put off

Employee Benefit Plan Expenses

- Adjusted to estimate the normalized earnings power of the employer company
- Adjustments imply company may achieve this level of earnings indefinitely
- Always consider:
  - Industry norms and comparable company analysis
  - Company-specific benefit expenses
  - Management's estimation of sustainable employee benefit expenses

Interest-Bearing Debt

- Impacts on the overall equity value
- Use a measurement of total invested capital
  - Total interest-bearing debt + Total equity
- ESOP debt is also a contingent obligation of the employer company

Capital Structure

- The mix of debt and equity
- Appropriate rate of return
- Examine the financial strength of the employer company
  - Collateral value of assets
  - Market value of interest-bearing debt
  - Ratio analysis:
    - Debt to equity
    - Return on assets, equity
    - Fixed asset turnover, total asset turnover
    - Long-term capital expenditures and requirements
    - Long-term working capital needs and requirements

Volatility of Earnings

- Temporary or trending
- Systematic or unsystematic
- Valuation analyst must consider the following:
  - Any changes in business operations, financial performance, cyclicality, etc.
  - Merger and acquisition market
  - Assessment of current vs. longer-term financial goals, forecasts
  - Volatility in guideline companies, economic factors and external variables

Repurchase Obligation

- Competition for cash
  - ESOP repurchase obligation needs vs. corporate needs
  - Business strategy influenced by the ESOP repurchase obligation
- ESOP loan requirements and RO dictate benefit levels rather than the other way around
- Steers purpose of ESOP away from being primarily employee-focused (retain and attract better employees)
- Longer term funding requirements
  - ESOP share purchase requirements
  - Sustaining the level of benefits for newer employees
- Growth rates, discounts rates, and pricing multiples are all valuation factors that may be affected by the RO

Valuation Issues Associated with the Repurchase Obligation

- Company's strategic plan
  - Corporate growth vs. retirement benefit obligation
- Plan design and maturity
  - Employee census and actuarial analysis
- Satisfying the RO
  - Sources of liquidity, funding for departing plan participants
- Repurchase strategy
  - Redeeming vs. recycling and plan payout provisions
- Sustainability and maintenance of the ESOP
  - Is the ESOP still a sustainable option and is employee ownership still management's primary objective

Assumption – Company wants to stay Employee Owned

- In order to sustain the corporate culture have to find a way to sustain share allocations within the ESOP
- Possible Solutions
- Stock contributions
- Recycling (internal or external)
- Leveraged repurchase
- Rebalancing/Reshuffling/Stock Fund
- Creative Contribution Formulas

Sustaining Share Allocations

- Stock contributions
- Company makes its annual contribution to the ESOP in the form of company stock
  - Shares are allocated in the same manner as the released shares were allocated
  - Contribution of treasury shares may be “dilutive” to existing ESOP shares
  - But “dilution is relative” – any issuance may be regarded as dilutive in the sense that more share are then outstanding, but not necessarily on a value per share basis if the contribution is in lieu of cash that would be paid.
- Impact on valuation and legacy ESOP participants….
- Impact on synthetic equity….

Sustaining Share Allocations

- Recycling in general
- The idea is that the shares which would have been distributed to terminated participants stay in the ESOP or are recontributed
- This may still be reviewed as dilutive if company was counting on reduced number of shares outstanding from redemptions, but dilution is limited to the number of shares redeemed
- Impact on valuation and legacy ESOP participants….
- Impact on synthetic equity….

Sustaining Share Allocations

- "Internal" recycling
  - Company contributes cash to the ESOP as now, but the cash is retained by the plan since no loan payment is due
  - The ESOP uses the cash to liquidate the shares in the account of participants who are entitled to a distribution
  - The shares from those participants are reallocated among the current employee participants entitled to an allocation
  - The amount of the contribution may depend on the repurchase liability for the year
  - Impact on valuation and legacy ESOP participants….
  - Impact on synthetic equity….

Sustaining Share Allocations

- "External" recycling
  - Essentially the same as stock contribution, but tied to the shares distributed to keep the number of outstanding shares constant
  - The ESOP would continue to distribute shares to terminated participants
  - Company would contribute some or all of the distributed shares to the ESOP for allocation to current employee participants
  - External recycling can result in less year to year fluctuations in the amount of contribution to the Plan that internal recycling.
  - Impact on valuation and legacy ESOP participants….
  - Impact on synthetic equity….

Sustaining Share Allocations

Redeem v. Recycle Illustration

- Assumptions: Company has an equity value of $10 million, or $10.00 per share, today and needs to repurchase 100,000 shares from ESOP participants for $1 million

Impact of Redeeming

		Before		Redemption		After
Aggregate Equity Value	$	10,000,000	$	1,000,000	$	9.000,000
Number or Shares Outstanding		1,000,000		100,000		900,00
Value per Share	$	10.00	$	10.00	$	10.00

Impact of Recycling

		Before		Redemption		After
Aggregate Equity Value	$	10,000,000	$	1,000,000	$	9.000,000
Number or Shares Outstanding		1,000,000		100,000		1,000,000
Value per Share	$	10.00	$	10.00	$	9.00

Sustaining Share Allocations

- Leveraged Repurchase
  - The ESOP may purchase shares from company with a loan from the company which will provide shares for allocation over a number of years
  - The shares may be those purchased from share distributed from the ESOP or treasury shares
  - A leveraged purchase may allow for allocation over a number of years, which may help if the number distributed in a year is larger that the amount of the anticipated annual contribution

Sustaining Share Allocations

- Rebalancing/Reshuffling/Stock Fund
  - Idea is that the accounts of all participants, old and new, have the same ratio of stock and cash
  - If cash is allocated and retained in the ESOP, the shares are either moved between accounts, retaining the same account value, but balancing the investment between cash and stock within the plan
  - The shares themselves may be moved among participant accounts (reshuffling) or the ESOP may account for the shares in a fund to which participants would have interests
  - Impact on valuation and legacy ESOP participants….
  - Impact on synthetic equity….

Sustaining Share Allocations

- Creative Allocation Formula
- Allocation formula for contributions might be designed to put more shares in hands of Have Nots
  - Example: Perhaps employees with less than five years of service receive a higher contribution (subject to passing applicable
- Non-discrimination requirements)
  - Example: Front load first year allocation (should not be any highly compensated employees)
- Exclude Highly Compensated Employees from Allocation

Sustaining Share Allocations

- Next steps
  - Update repurchase liability study
  - Consult with your ESOP advisors regarding the pros and cons of each methodology
    - The ESOP's financial advisor can assess the impact of each on valuation
    - The ESOP's administrator, can help assess the long-term contribution and repurchase liability obligations
  - The ESOP and/or the distribution policy may need to be amended

How is Sustainability Achieved?

- Strong business fundamentals
  - Effective vision and business strategy
  - Strong financial management
    - Reasonable financial returns for business risk
    - Long range financial planning incorporating all capital claims
  - Strong corporate leadership and succession planning
    - Effective corporate governance
    - Thoughtful management succession planning
  - Commitment to ESOP ownership
    - Shareholders, Board of Directors, Management
    - Healthy ESOP culture and communications strategy

Mature ESOP Planning – Collaborative Process

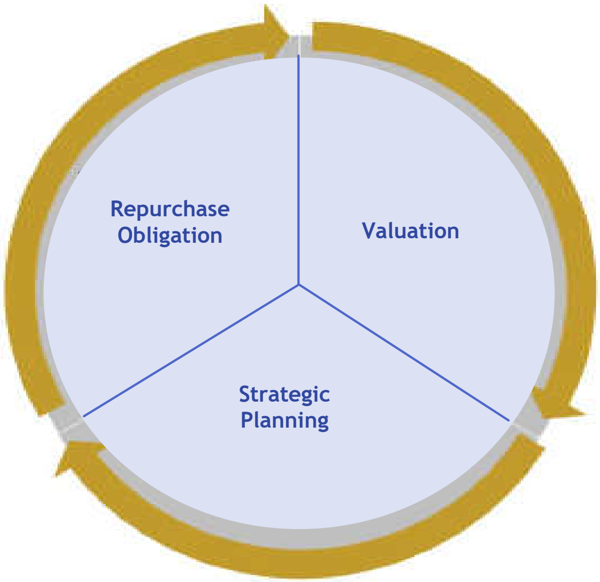
- Vital for Trustees and Management to Understand How the ESOP Impacts Their Business
  - Short term
  - Long term
- Need to Have an Understanding of the Impact of ESOP Policy Decisions
  - Business strategy
  - Cash flow
  - Benefit levels
- Important to Align ESOP Policy With Intent and Business Strategy

Mature ESOP Planning – Focus Factors

- Trustees and managers should maintain integrated thinking regarding:
  - ESOP policies
  - Repurchase obligation
  - Value trajectory
  - Benefit expectations
  - Future cash flow implications
  - Management succession
- "The ESOP should not dictate your corporate strategy – it should be controlled and aligned with this desired strategy"

Mature ESOP Planning – Iterative Process

- Proactive planning and understanding the long range implication of various operational strategies that exist within the context of managing an ESOP
  - Transaction design and structure
  - Internal loan term
  - Annual contribution amounts and form
  - Distribution policies
  - Repurchase funding needs
  - Redemption/re-levering/recapitalization strategies



Case Study:1

- Mature ESOP
- 2 Business Lines
  - One, growing niche
  - One, increasingly commoditized
- Claims on Capital
  - Not used to sufficiently expand niche line
  - Focus on sustaining Share Price vs. entrepreneurial focus

Case Study:2

- Mature majority C-Corp ESOP
- Very successful growth in share value since inception
  - Over 150%
  - Benefit approaching 50% of pay as allocated
  - Concern over ‘running out of shares’ in a few years
  - Concern over covering international employees
- Strong Employee Ownership culture
- Need for Capital:
  - Repurchase Obligation
  - Individual shareholder liquidity
  - Growth

Case Study:3

- Mature ESOP
- 1,500 plan participants; 400 employees
- No more shares for newer employees, including leadership
- Founder desires an exit from this partial minority ESOP
- Management wants to grow the company through acquisition and organic growth
- Management and new board want equity participation
- Failed private equity sale
- Culture solid, but not leveraging ESOP

Case Study:4

- Mature ESOP
- Minority interest C-Corporation
- Son, who led most of growth of the company evaluating alternatives after founder passes
- Outstanding performer in a competitive industrial sector

- Interest from Competitors to buy them
  - Theoretically higher price?
- Interest from Management
  - Can they afford to purchase company?
- Interest from private equity
  - Will this change the culture?
  - Culture clearly drives differentiation

Case Study:5

- Mature ESOP
- Minority interest S-Corp
- 90% of the Stock owned by 10% of the workforce
- Significant shifting Industry Dynamics
- Globalization
- Larger Companies
- New Domestic competition
- Acquire or be acquired?
- Long tenured management prioritizing ‘holding’ value for near in retirees
- New management prioritizing continued growth

Post Script

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Erin D. Hollis, ASA, CDBV, is a Director at Marshall & Stevens Incorporated. She works within the financial practice group and with ESOP clients on financial analysis and consulting services needs.

Experience – Since 2000, Ms. Hollis has worked with advisors and closely-held business owners for valuation needs, and has experience providing valuation advisory and economic analysis services in the areas of litigation, taxation, transactional, and planning purposes. Erin has provided professional services in industries, such as manufacturing, construction, transportation, agricultural, distribution, retail, wholesale, and a wide range of service industries.

She is a qualified expert witness, and has testified for various marital and corporate litigation matters. She is a prolific author on the subject of business valuation, and has written for several industry trade publications and as a contributing author for professional organizations. Erin sits on the Business Valuation Committee of the American Society of Appraisers (ASA) and is a past ASA Chicago Chapter President. She is also a member of The ESOP Association and the (NCEO) National Center for Employee Ownership, and has spoken at conferences on the topic of ESOPs.

Education – Erin received a B.A. and B.S. from Michigan State University. She is an Accredited Senior Appraiser (ASA) with the American Society of Appraisers, and Certified in Distressed Business Valuation (CDBV) with the Association of Insolvency & Restructuring Advisors (AIRA).

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Erin K. Turley, is a Partner at McDermott Will & Emery. She focuses her practice on employee benefits matters. She has extensive experience handling issues pertaining to the Employee Retirement Income Security Act of 1974 (ERISA) and employee stock ownership plans (ESOPs).

Experience – With respect to ERISA, Erin focuses on employee benefits, including qualified, nonqualified, and executive and deferred compensation and welfare benefit plans, as well as on regulatory compliance with the Internal Revenue Code, ERISA, the Consolidated Omnibus Budget Reconciliation Act (COBRA), the Health Insurance Portability and Accountability Act (HIPAA) and Patient Protection and Affordable Care Act (PPACA). She also advises employers on the design, implementation and administration of tax-qualified and nonqualified retirement plans, and health and welfare benefit plans.

Erin regularly represents clients before the Internal Revenue Service and the Department of Labor in audit and correction matters. She has advised employers on issues raised in connection with corporate mergers, acquisitions and divestitures as they relate to the various benefit plans maintained by the affected corporate entity or entities.

Erin focuses her ESOP practice on the design and implementation of ESOP transactions and provides ongoing legal counsel to ESOP-owned companies. She has been involved in hundreds of transactions, including leveraged buyouts, mergers, acquisitions, and the structuring and financing of ESOPs using private equity. Erin also has extensive experience representing lenders in designing and negotiating credit facilities specifically tailored to the needs of ESOP-owned companies.

Erin writes and speaks frequently on ERISA and ESOP issues.

Education –

- Georgetown University Law Center, LLM, with distinction, 1996
- Texas Tech University, JD, *magna cum laude*, 1994
- University of Dallas, BA, 1989