

## ESOP Valuation Insights

## THE MARKET APPROACH—ESOP EMPLOYER STOCK VALUATIONS DURING ECONOMIC TURMOIL

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*The market approach is a generally accepted business valuation and security analysis approach. In many cases, it is particularly relevant to the fair market value valuation of (1) an ESOP sponsor company and (2) the employer corporation shares owned by the plan participants. There are generally accepted practices and procedures with respect to the application of the market approach, particularly within the context of an ESOP employer stock valuation. However, it is challenging for even the experienced valuation analyst to perform a market approach valuation analysis during periods of severe economic turmoil. This discussion identifies some of the factors that the valuation analyst should consider in the application of the market approach in an employer stock valuation during such periods.*

### INTRODUCTION

Statistics published by The ESOP Association in 2008 indicated that there are an estimated 11,500 employee stock ownership plans (ESOPs) in the United States. These ESOPs cover approximately 10 percent of the private sector workforce, or roughly 10 million employees.

While the number of publicly traded ESOP companies is estimated at only 330, or approximately three percent of all ESOPs, these companies reportedly employ just under 50 percent of the 10 million employee owners in our country.

Because most ESOP-owned employer corporations are privately held and are therefore not required to file public reports with the Securities and Exchange Commission, statistics regarding ESOP sponsor companies are difficult to confirm. The most current information available from The ESOP Association indicated that the total value of the assets owned by ESOPs was estimated at \$800 billion as of year-end 2006.

The Employee Retirement Income Security Act of 1974 (ERISA) represents the first piece of major legislation that facilitated the establishment of ESOPs. ERISA and the Internal Revenue Code require that all assets held by an ESOP, including the employer corporation securities, should be valued at least once each year. If the asset base of the ESOP includes employer corporation securities that are not publicly traded, then the annual valuation should be completed by a qualified, independent appraiser.

This Statement is particularly true based on:

1. the sizable value represented by ESOP-owned employer corporation stock and
2. the significance of that value with respect to the retirement accounts of the ESOP employee/participants.

The employer corporation stock valuation process completed by the independent appraiser plays an important role with regard to the ongoing operation and administration of the typical ESOP.

A well-reasoned, thorough employer corporation stock valuation typically will consider each of the three generally accepted business valuation approaches: (1) the income approach, (2) the market approach, and (3) the asset-based approach.

Generally, the asset-based approach is relied upon less often to estimate employer corporation stock value than the other two business valuation approaches. As a result, most employer corporation stock valuation opinions are based on a weighting of the estimated values resulting from the income approach and the market approach.

This discussion focuses on the generally accepted process completed by a qualified appraiser to develop a market approach value indication of:

1. the ESOP sponsor company and
2. the employer corporation stock.

Additionally, this discussion addresses some of the considerations faced by the qualified appraiser in performing a market approach analysis of an ESOP sponsor company when the “market” and the overall economy are in a state of significant fluctuation and instability.

### ESOP EMPLOYER STOCK VALUATION AND THE RELEVANT STANDARD OF VALUE

ERISA requires that an ESOP pays no more than “adequate consideration” when purchasing employer company securities. Further, the periodic annual valuations of the ESOP sponsor company securities, commonly referred to as “valuation updates,” also should adhere to this adequate consideration principle.

The adequate consideration principle generally follows the specific guidelines for the standard (or definition) of fair market value established in Internal Revenue Code Revenue Ruling 59-60.

On May 17, 1988, the U.S. Department of Labor (DOL) issued the “Proposed Regulation Relating to the Definition of Adequate Consideration” for ESOP-based transactions. For purposes of ERISA and the DOL adequate consideration regulation, and as established in the Internal Revenue Code, fair market value is defined as:

The price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset.<sup>1</sup>

### GENERALLY ACCEPTED ESOP EMPLOYER STOCK VALUATION PRACTICES AND PROCEDURES

Adequate consideration within the ESOP community typically is equated with the fair market value standard of value. Accordingly, the generally accepted valuation process completed by a qualified appraiser for the purpose of estimating the fair market value of an ESOP sponsor company—and of

its underlying securities—requires consideration of the following factors outlined in Revenue Ruling 59-60:

1. the nature of the business and the history of the enterprise from its inception
2. the economic outlook in general and the condition and outlook of the specific industry in particular
3. the book value of the stock and the financial condition of the business
4. the earnings capacity of the company
5. the dividend-paying capacity of the company
6. whether or not the enterprise has goodwill or other intangible value
7. sales of the stock and size of the block to be valued
8. the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter

*“... Revenue Ruling 59-60 factor number eight specifically addresses the consideration of the market approach.”*

Each of the first seven factors identified in Revenue Ruling 59-60 exerts some influence on the valuation variables and valuation procedures considered to develop an indication of value using the three generally accepted valuation approaches (i.e., income, market and asset-based). However, Revenue

Ruling 59-60 factor number eight specifically addresses the consideration of the market approach.

In essence, Revenue Ruling 59-60 factor number eight suggests that, in order to estimate the fair market value of an ESOP sponsor company, the subject sponsor company should be analyzed in relation to reasonably comparable publicly traded entities operating within the same industry—that is, the “market.”

In effect, Revenue Ruling 59-60 factor number eight instructs the qualified appraiser to treat, at least initially, the subject ESOP sponsor company as if it was a publicly traded company operating within the market. A thorough market analysis requires a detailed analysis and comparison of the following factors with regard to the ESOP sponsor company:

1. business focus (e.g., products and/or service)
2. size (e.g., assets or revenue)
3. geographic coverage (i.e., markets served)
4. capital structure (debt and equity financing mix)
5. financial performance and related trends
6. historical and expected growth

Each of the above factors should be analyzed for the sponsor company in relation to the identified, market-based companies deemed to represent a reasonable “guideline company” group.

The objective of the market approach analysis is to quantify and appropriately select market-based pricing indicators (i.e., “multiples”) that can be applied to the subject ESOP sponsor company relevant financial and operating fundamentals.

The generally accepted market-based pricing multiples include price (typically represented by the market value of invested capital (MVIC)—that is, the market value of debt and the market value of equity comprising the capital structure of identified guideline publicly traded companies) to:

1. earnings before interest and taxes (EBIT);
2. earnings before interest, taxes, depreciation, and amortization (EBITDA);
3. revenues; and
4. tangible book value of invested capital (TBVIC).

## SUMMARY MARKET APPROACH ANALYSIS— RETAIL GROCERY ESOP SPONSOR COMPANY

Let’s assume that a qualified valuation analyst is conducting an ESOP employer stock valuation update as of December 31, 2007, with regard to a Midwest-based, closely held retail grocery chain. This retail grocery chain is called ABC Stores Corporation (“ABC”). The ESOP owns 20 percent of the issued and outstanding common stock of ABC, clearly positioning the ESOP as a noncontrolling interest owner.

ABC is a relatively large company, with 125 stores and \$1 billion in annual revenue, and historically profitable. Therefore, a qualified valuation analyst reasonably could conclude that the market approach represents a relevant process for the purpose of developing a reliable indication of the fair market value of ABC.

Through detailed research and analysis, the valuation analyst identifies five publicly traded companies operating within the retail grocery sector. This analysis results in the information contained in Table 1.

As indicated, ABC generally operates at a level below the median operating structure noted for the five guideline publicly traded companies. Ignoring all other factors (e.g., earnings trends, growth trends, and relative profitability), such a circumstance typically would result in the selection of pricing multiples for ABC at or below the market-based

pricing multiples observed for the guideline publicly traded companies.

## EBIT Analysis

Table 2 presents a summary of the guideline publicly traded company EBIT analysis. As indicated, the EBIT analysis presented in Table 2 focuses on:

1. the latest 12-month (LTM) and 5-year average EBIT realized by each of the guideline publicly traded companies,
2. the historical EBIT growth recognized by each guideline publicly traded company,
3. the variability in EBIT growth recognized by each guideline publicly traded company (as measured by the coefficient of variation, with higher percentages representing greater variability and, therefore, higher risk), and
4. the indicated pricing multiples for each guideline publicly traded company based on the observed relationship between MVIC and EBIT.

*“... ABC generally operates at a level below the median operating structure noted for the five guideline publicly traded companies.”*

Based on this comparative analysis, the ABC historical EBIT operating performance is most comparable to the EBIT operating performance observed for Comparable Company 4. ABC recognized slightly higher EBIT growth and lower variability

in EBIT growth relative to Comparable Company 4. And, ABC is slightly smaller than Comparable Company 4, based on (1) number of stores operated (125 for ABC compared to 150 for Comparable Company 4) and (2) annual revenue level (\$1.5 billion for ABC compared to \$1.575 billion for Comparable 4).

## EBITDA Analysis

Table 3 presents a summary of the guideline publicly traded company EBITDA analysis. As indicated, the EBITDA analysis presented in Table 3 focuses on:

1. the LTM and 5-year average EBITDA realized by each of the guideline publicly traded companies,
2. the historical EBITDA growth recognized by each guideline publicly traded company,
3. the variability in EBITDA growth recognized by each guideline publicly traded company, and
4. the indicated pricing multiples for each guideline publicly traded company based on the observed relationship between MVIC and EBITDA.

Based on comparative analysis, the ABC historical EBITDA operating performance is most comparable to the EBITDA operating performance observed for Comparable Company 4.

Similar to the EBIT analysis, ABC recognized slightly higher EBITDA growth and lower variability in EBITDA growth relative to Comparable Company 4. However, ABC is slightly smaller than Comparable Company 4 based on (1) number of stores operated and (2) annual revenue level.

### Revenue Analysis

Table 4 presents a summary of the guideline publicly traded company revenue analysis. As indicated, the revenue analysis presented in Table 4 focuses on:

1. the LTM and 5-year average revenue recognized by each of the guideline publicly traded companies,
2. the historical revenue growth recognized by each guideline publicly traded company,
3. the variability in revenue growth recognized by each guideline publicly traded company, and
4. the indicated pricing multiples for each guideline publicly traded company based on the observed relationship between MVIC and revenue.

Based on comparative analysis, the ABC historical revenue operating performance is most comparable to the revenue operating performance observed for Comparable Company 4. From a revenue performance perspective, ABC recognized:

1. slightly higher EBIT growth and lower variability in revenue growth than Comparable Company 4, and
2. superior EBITDA returns on revenue relative to similar performance measures for Comparable Company 4.

With regard to the market-based revenue multiples observed, it is important to note the strong positive relationship between EBITDA-based return on revenue and the related revenue multiple.

As indicated in Table 4, Comparable Company 4 generated EBITDA-based returns on revenue at the high end of the observed range; consequently, the market rewarded Comparable Company 4 with the highest revenue multiples.

### Market Approach—Value Summary

Table 5 presents a summary of the market approach, based on the application of the selected, market-based pricing

multiples to the relevant ABC operating fundamentals. As presented in Table 5, and based on the application of the selected, market-based pricing multiples to the relevant ABC operating fundamentals, the indicated MVIC for ABC ranges from \$780 million to \$1.053 billion.

Based on the assumption that investors would attribute the greatest weight to indications of value attributable to the expected earnings and cash flow of ABC, the indicated MVIC for ABC—based on the market approach—is \$940 million.

The indicated value is based on market-based transaction pricing relating to the transfer of noncontrolling ownership interests in the guideline publicly traded companies. Therefore, the concluded value is considered to represent a “publicly traded equivalent value,” or a noncontrolling, marketable ownership interest level of value.

To arrive at the estimated noncontrolling, marketable equity value of ABC, all interest-bearing debt expected to be paid as of December 31, 2007, should be subtracted from the concluded MVIC. (Further adjustments may be required to address the detrimental impact on value attributable to limited marketability inherent in the concluded equity value of ABC, but such adjustments are beyond the scope of this discussion.)

## ESOP EMPLOYER STOCK VALUATION UPDATES AND MARKET CORRECTIONS

Based on the market-based analysis previously described, the estimated MVIC for ABC as of December 31, 2007, was \$940 million. Between January 1, 2008, and December 31, 2008, let's assume that the market and economic shifts summarized in Table 6 occurred.

The economic indicators referenced in Table 6 provide strong evidence that a general decline in “market value” in the range of 34 percent to 41 percent occurred between December 31, 2007, and December 31, 2008. Additionally, the following factors serve as strong indicators regarding the overall decline in economic activity that occurred between year-end 2007 and year-end 2008:

1. a significant reduction in the cost of money (i.e., decrease in the prime rate),
2. a significant decrease in housing starts, and
3. a significant increase in the unemployment rate.

Given the shift in market and economic conditions that occurred between year-end 2007 and year-end 2008, a December 31, 2008, ESOP employer stock valuation update with regard to ABC—representing the only time that ABC was valued since December 31, 2007—presents a challenge. That challenge to the valuation analyst relates to estimating

the appropriate impact that existing market and economic conditions should exert on the value of ABC.

Based on the general decline noted in the market indices, the valuation analyst may simply conclude—prematurely—that the equity value of ABC declined 34 percent to 41 percent between year-end 2007 and year-end 2008.

With regard to ABC and the impact that deteriorating economic conditions may exert on the valuation of ABC as of December 31, 2008, it is worth noting that, as presented in Table 6, the S&P Grocery Index decreased approximately 9.4 percent between year-end 2007 and year-end 2008.

The fact that the magnitude of the decrease in the S&P Grocery Index between year-end 2007 and year-end 2008 was approximately one-fourth the level of the general decline noted for broad industry indices is noteworthy. These factors suggest that participants within the retail grocery industry were somewhat insulated from the overall decline experienced by the market.

This circumstance is likely attributable to the fact that investors recognize some continuing level of basic consumer demand will exist with regard to the products and services offered by retail grocers.

## ADDRESSING MARKET CORRECTIONS IN AN ESOP EMPLOYER STOCK VALUATION UPDATE

The generally accepted school of thought is that a pervasive and significant shift in the economy and market values such as the market correction noted between year-end 2007 and year-end 2008 will affect the value of all market participants—whether publicly traded or privately held.

However, and as evidenced by the decline in the S&P Grocery Index relative to the declines noted in the broader indices, the industry in which a particular company operates can mitigate, or exacerbate (e.g., a company in the financial services sector) the impact that a general economic decline may exert on the valuation of an ESOP sponsor company.

Other factors that the valuation analyst should consider when estimating the value of an ESOP sponsor company in the circumstance of significant economic change and instability include the following:

1. the depth and experience of the management group at the ESOP sponsor company, and the management group's demonstrated ability to perform in an environment characterized by significant economic change

2. whether the projected financial performance of the ESOP sponsor company reasonably reflects the anticipated, near-term impact of the general shift in the overall economy and the market, with a projected return to growth and profitability levels more in line with historical company/industry norms within a reasonable period of time
3. how the market areas and regions serviced by the ESOP sponsor company typically respond to general shifts in the broad economy
4. how, and whether it is reasonable, to modify the weight applied to the value indications resulting from the market approach and the income approach based on the level of uncertainty inherent in the market analysis
5. the level and timing of capital investment/improvement programs in relation to the timing of the economic shift

The appropriate consideration and weighting of the factors noted above should result in a valuation conclusion that appropriately reflects the impact of significant economic and market uncertainty existing as of the valuation date.

*“These ESOP sponsor-company-specific factors often serve to mitigate—but in certain cases may exacerbate—the impact that economic and market shifts exert on the value of the company.”*

## SUMMARY AND CONCLUSION

Economic and market change is inevitable. However, and as noted economist John Mitchell recently stated, “One thing you can state with certainty regarding all prior recessions is that each one ended, and this one

will end, too.” Completing the valuation of an ESOP sponsor company during a period of significant economic and market fluctuation requires: (1) adherence to generally accepted valuation practices by a qualified appraiser and (2) the identification and analysis of key factors specific to the subject ESOP sponsor company. These ESOP sponsor-company-specific factors often serve to mitigate—but in certain cases may exacerbate—the impact that economic and market shifts exert on the value of the company. Some of these company-specific factors were identified in this discussion.

### Note:

1. Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17,632 (1988), p. 17,634.

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**Table 1**  
**ABC Stores Corporation**  
**Market Approach Valuation Analysis**  
**Summary of Guideline Company Operating Results**  
**As of December 31, 2007**

<u>Company</u>	<u>Stores</u>	<u>Assets (\$Mil)</u>	<u>Revenue (\$Mil)</u>	<u>MVIC (\$Mil)</u>	<u>Debt % MVIC</u>
Comparable Company 1	350	3,045	7,350	1,900	40
Comparable Company 2	250	1,950	4,200	1,400	25
Comparable Company 3	200	1,305	2,730	1,100	22
Comparable Company 4	150	783	1,575	814	32
Comparable Company 5	100	609	1,155	543	18
Median	200	1,305	2,730	1,100	25
ABC	125	870	1,500	TBD	NA

**Table 2**  
**ABC Stores Corporation**  
**Market Approach Valuation Analysis**  
**Summary of Guideline Company EBIT Analysis**  
**As of December 31, 2007**

<u>Company</u>	<u>LTM EBIT (\$Mil)</u>	<u>5-Year Average EBIT (\$Mil)</u>	<u>5-Year Growth Rate %</u>	<u>Coefficient of Variation %</u>	<u>MVIC/LTM EBIT</u>	<u>MVIC/5-Year Average EBIT</u>
Comparable Company 1	190	152	14.0	8.0	10.0	12.5
Comparable Company 2	156	125	10.0	10.0	9.0	11.2
Comparable Company 3	129	104	9.0	12.0	8.5	10.6
Comparable Company 4	102	81	8.0	14.0	8.0	10.0
Comparable Company 5	78	62	7.0	16.0	7.0	8.8
Median	129	104	9.0	12.0	8.5	10.6
ABC	115	104	8.5	2.0	<b>8.0</b>	<b>10.0</b>

**Table 3**  
**ABC Stores Corporation**  
**Market Approach Valuation Analysis**  
**Summary of Guideline Company EBITDA Analysis**  
**As of December 31, 2007**

<u>Company</u>	<u>LTM EBITDA (\$Mil)</u>	<u>5-Year Average EBITDA (\$Mil)</u>	<u>5-Year Growth Rate %</u>	<u>Coefficient of Variation %</u>	<u>MVIC/ LTM EBITDA</u>	<u>MVIC/ 5-Year Average EBITDA</u>
Comparable Company 1	238	190	12.0	8.0	8.0	10.0
Comparable Company 2	195	156	8.0	10.0	7.2	9.0
Comparable Company 3	161	130	7.0	12.0	6.8	8.5
Comparable Company 4	128	101	6.0	14.0	6.4	8.1
Comparable Company 5	98	78	5.0	16.0	5.5	7.0
Median	161	130	7.0	12.0	6.8	8.5
ABC	144	130	6.5	2.0	<b>6.4</b>	<b>8.1</b>

**Table 4**  
**ABC Stores Corporation**  
**Market Approach Valuation Analysis**  
**Summary of Guideline Company Revenue Analysis**  
**As of December 31, 2007**

<u>Company</u>	<u>LTM Revenue (\$Mil)</u>	<u>5-Year Average Revenue (\$Mil)</u>	<u>5-Year Growth Rate %</u>	<u>Coefficient of Variation %</u>	<u>MVIC/ LTM Revenue</u>	<u>MVIC/ 5-Year Average Revenue</u>	<u>LTM EBITDA Return %</u>	<u>5-Year Average EBITDA Return %</u>
Comparable Company 1	7,350	5,880	8.0	6.0	0.26	0.32	3.2	3.2
Comparable Company 2	4,200	3,360	6.0	8.0	0.33	0.42	4.6	4.6
Comparable Company 3	2,730	2,184	5.0	10.0	0.40	0.50	5.9	6.0
Comparable Company 4	1,575	1,260	4.0	11.0	0.52	0.65	8.1	8.0
Comparable Company 5	1,155	924	3.0	13.0	0.47	0.59	8.5	8.4
Median	2,730	2,184	5.0	10.0	0.40	0.50	5.9	6.0
ABC	1,500	1,350	4.5	2.0	<b>0.52</b>	<b>0.65</b>	9.6	9.6

**Table 5**  
**ABC Stores Corporation**  
**Market Approach Valuation Analysis**  
**Value Indications and Value Conclusion**  
**As of December 31, 2007**

<u>Fundamental</u>	<u>ABC Value (\$Mil)</u>	<u>Market-Based Median Pricing Multiple</u>	<u>ABC Selected Pricing Multiple</u>	<u>ABC Indicated MVIC (\$Mil)</u>
LTM EBIT	115	8.5	8.0	920
5-Yr. Avg. EBIT	104	10.6	10.0	1,040
LTM EBITDA	144	6.8	6.4	922
5-Yr. Avg. EBITDA	130	8.5	8.1	1,053
LTM Revenue	1,500	0.40	0.52	780
5-Yr. Avg. Revenue	1,350	0.50	0.65	878
Concluded MVIC—ABC				940

**Table 6**  
**ABC Stores Corporation**  
**Market Approach Valuation Analysis**  
**Analysis of Relevant Market Indices**  
**Market Shift Between 12/31/07 and 12/31/08**  
**As of December 31, 2008**

<u>Index/Measure</u>	<u>12/31/07</u>	<u>12/31/08</u>	<u>% Change</u>
Dow Jones Industrial Average	13,264.82	8,776.39	(33.8)
S&P 500	1,468.36	903.25	(38.5)
Nasdaq	2,652.28	1,577.03	(40.5)
<b>S&amp;P Grocery Index</b>	<b>193.7</b>	<b>175.4</b>	<b>(9.4)</b>
Prime Rate	7.25%	3.25%	(55.2)
Housing Starts	1,355,200	904,300	(33.3)
Unemployment Rate	4.9%	7.2%	46.9