

Best Practices

Valuation Considerations in the Sale of Employer Corporation Stock to an ESOP and to Other Parties

Chip Brown, CPA, Steve Whittington, and Robert F. Reilly, CPA

Sometimes close corporations sell common stock at the same time to an employee stock ownership plan (ESOP) and to a non-ESOP investor. In such an instance, for many reasons, the values (i.e., prices) of the two blocks of stock may not be the same. This discussion summarizes the different considerations between (1) valuing employer stock for an ESOP purchase transaction and (2) valuing employer stock for a non-ESOP purchase transaction.

INTRODUCTION

An employee stock ownership plan (ESOP) sponsor company may be involved in many types of stock sale transactions over the life of the plan. Valuation analysts who practice in the ESOP discipline are most commonly asked to analyze stock sale transactions between (1) the sponsor company and the ESOP or (2) the selling/founding shareholders and the ESOP.

However, the sponsor company (or the selling shareholders) may also be involved with the sale of the employer stock outside of the ESOP. For example, the sponsor company could sell employer stock to key employees, independent directors, strategic partners, and capital providers.

There may also be sales or other transfers of employer stock that do not involve either the sponsor company or the ESOP. For example, key employees (and other non-ESOP parties) who own the employer stock may transfer that stock in a gift, in an estate, as a charitable contribution, in a marital dissolution, and so on.

First, this discussion summarizes the generally accepted business valuation approaches with regard to sponsor company securities. In particular, this discussion considers general valuation factors relat-

ed to the level of value, the employer stock rights and privileges, and the level at which funds are transferred from the sponsor company to the ESOP.

These factors may affect the value of all employer stock that sold or transferred to all parties (including the ESOP).

Second, this discussion summarizes specific valuation analyst considerations with regard to sponsor company stock sales to the ESOP versus to other (non-ESOP) parties. This discussion explores the reasons why two employer stock sale transactions that occur on the same day may occur at two different prices.

Such transactions can be both fair to the ESOP and in compliance with ERISA and other regulatory requirements. As will be considered, such price differences may be due to differences (1) in the subject securities (e.g., voting stock versus non-voting stock) or (2) in the size of the subject block of employer stock.

In addition, two identical blocks of identical employer stock can be sold on the same day at two different prices, with one block sold to the ESOP and one block sold to, say, a key employee. This discussion explains some of the reasons for such a price (and value) difference.

VALUATION ANALYST CONSIDERATIONS IN SPONSOR COMPANY STOCK SALES TO THE ESOP

This discussion first summarizes the generally accepted approaches and methods with regard to the valuation of the sponsor company shares to be sold to the ESOP.

In addition to the generally accepted considerations that apply to any business or stock valuation, the following valuation analyst considerations may make the ESOP transaction block of stock different from an otherwise identical block of stock:

1. The level of value to apply in the employer stock valuation
2. The contractual rights and privileges related to the ESOP-owned stock
3. How the ESOP purchase of the employer stock will be financed

BUSINESS AND STOCK VALUATION APPROACHES AND METHODS

There are three generally accepted approaches to the valuation of the sponsor company and the sponsor company shares.

Many close corporation owners and industry consultants often believe that there are specific rules of thumb or unique shortcut formulas that are only applicable to companies in the subject industry. These rules or formulas often relate to some pricing multiple that is multiplied by a company-specific metric.

For example, these industry-specific formula may include the following:

1. A multiple \times annual company revenue
2. A multiple \times annual company EBITDA
3. A multiple \times number of company customers
4. A multiple \times number of homes passed by the company wire, pipe, cable, etc.

Nonetheless, when the valuation analyst examines these so-called industry rules of thumb, they may be categorized into the three generally accepted business valuation approaches.

These generally accepted valuation approaches are listed below:

1. Income approach
2. Market approach

3. Asset-based approach

Income Approach

The income approach is based on the principle that the value of the employer corporation (or the employer stock) is the present value of the future income expected to be earned by the corporation owners.

There are many different ways to measure income for purposes of an income approach valuation analysis, including the following:

1. Net operating income
2. EBITDA
3. EBIT
4. Pretax net income
5. After-tax net income
6. Net cash flow

Each of these (and other) measures of sponsor company income may be applicable to the sponsor company valuation as long as the discount rate or capitalization rate corresponds to the selected income measure. A discount rate (also called a “present value discount rate”) is the required rate of return on an investment in the sponsor company.

There are a number of generally accepted models that the valuation analyst may use to estimate the discount rate. These models all incorporate the following:

1. Some measure of market-derived rate of return data
2. Some adjustment for the risk of the particular sponsor company

A capitalization rate is typically calculated as (1) the discount rate minus (2) the expected long-term growth rate in the particular income measure. So, let’s assume that the analyst selects net cash flow as the income measure for the valuation of the Alpha Sponsor Company (“Alpha”).

Let’s assume that the analyst concludes that 14 percent is the appropriate market-derived discount rate to apply to net cash flow. And, the analyst projects that the Alpha net cash flow will increase at the rate of 4 percent per year over the long term. In that case, the analyst would conclude a 10 percent direct capitalization rate (i.e. 14% discount rate – 4% growth rate = 10% capitalization rate).

There are two common income approach valuation methods:

1. The yield capitalization method
2. The direct capitalization method

The valuation analyst will typically use the yield capitalization method when the sponsor company income (however defined) is expected to change (increase or decrease) at a nonconstant rate in the future.

This valuation method requires a discrete projection of annual income for many years into the future (typically until the expected long-term growth rate stabilizes). The analyst calculates the business value as (1) the present value of the projected future cash flow plus (2) the present value of a terminal (or residual value) estimated at the end of the discrete period. Both value components are calculated using the above-described present value discount rate.

This valuation method is also called the discounted cash flow method. This name is often used even when cash flow is not selected as the measure of the sponsor company income.

The valuation analyst will typically use the direct capitalization method when the sponsor company income (however defined) is expected to change (increase or decrease) at a constant rate in the future. This method requires a one-year estimate of normalized income for the sponsor company. The analyst calculates the business value by dividing the one-year income estimate by the direct capitalization rate.

Let's assume the expected net cash flow for the Alpha is \$100. Then, based on the above-mentioned 10 percent direct capitalization rate, the Alpha business value would be \$1,000 ($\$100 \text{ net cash flow} \div 10\% \text{ capitalization rate} = \$1,000 \text{ value}$).

To see how different income measures can be used in the sponsor company valuation, let's assume that the Alpha estimated next period pretax income is \$1,200. And, based on a 33 percent income tax rate, the Alpha estimated next period after-tax income is \$800 (i.e., $\$1,200 \text{ pretax income} \text{ less } 33\% \text{ income tax rate}$).

Let's assume the analyst applies the appropriate cost of capital models to conclude an after-tax net income (and not net cash flow) capitalization rate of 8 percent. Applying this net-income-based 8 percent capitalization rate to the \$800 after-tax income estimate indicates that the Alpha business value is still \$1,000 (i.e., $\$800 \text{ after-tax income} \div 8\% \text{ after-tax capitalization rate} = \$1,000 \text{ value}$).

Next, let's assume the analyst adjusts the 8 percent after-tax income capitalization rate for income taxes. The direct capitalization rate income tax adjustment formula is: the after-tax rate of 8% \div (1 - income tax rate) = the pretax rate.

So, the corresponding pretax income direct capitalization rate is: $8\% \text{ after tax rate} \div (1 - 33\% \text{ income}$

tax rate) = 12% pretax rate. If the analyst applies the 12 percent pretax income capitalization rate to the \$120 pretax income estimate, the Alpha business value is still \$1,000.

These last two calculations also answer an income approach question commonly asked by an ESOP trustee: should the valuation be performed on a pretax basis or on an after-tax basis? As these calculations indicate, the answer to this question is: it doesn't matter.

As long as (1) the income measure and (2) the discount/capitalization rates are both adjusted by exactly the same income tax rate, then either income approach application should conclude the same business value.

Market Approach

The market approach is based on the principle that the sponsor company can be valued by reference to pricing guidance extracted from what investors paid in arm's-length transactions for comparative investments.

The most common market approach valuation methods are as follows:

1. The guideline publicly traded company method (GPTCM)
2. The guideline merger and acquisition transactions method (GMATM)
3. The backsolve method

In each of these methods, the valuation analyst identifies and analyzes market data regarding arm's-length transactions. Using these empirical data, the valuation analyst extracts pricing multiples to apply to the subject sponsor company.

These pricing multiples often include the following:

1. Price to revenue multiple
2. Price to book value multiple
3. Price to EBITDA multiple
4. Price to EBIT multiple
5. Price to pretax income multiple
6. Price to after-tax multiple
7. Price to cash flow multiple

The analyst typically will apply more than one pricing multiple in the market approach analysis. And, the analyst will typically apply more than one time period in the market approach analysis.

For example, the analyst may derive pricing multiples to apply to the sponsor company financial fundamentals for these different time periods:

1. Latest twelve months actual results
2. Next twelve months projected results
3. Three-year average actual results
4. Five-year average actual results

On each of the GPTCM and the GMATM analyses, the analyst first attempts to identify companies that are directly comparable to the sponsor company. Such comparable companies look very much like the sponsor company. They are about the same size, they operate in the same industry or profession, they may compete with each other, they have the same sources of supply, they have the same types of customers, and so forth.

When the analyst can identify such comparable companies, the market approach analysis is relatively easy. Of course, the analyst will have to adjust both the comparable companies and the sponsor company financial statements for nonoperating items, nonrecurring items, differences in accounting principles, and other so-called normalization adjustments.

However, then the analyst can often apply the derived mean or median pricing multiples to the sponsor company financial fundamentals. This use of mean or median multiples is appropriate because the selected comparable companies are so similar to the sponsor company. The analyst will typically synthesize (or weight) the various value indications into one sponsor company market approach business value estimate.

However, it is rare for the analyst to identify comparable companies for most sponsor companies. Compared to most publicly traded or recently acquired companies, the typical sponsor company is much smaller, operates regionally, and operates in a specialized segment of an industry.

Therefore, commonly, valuation analysts select and rely on guideline companies. Guideline companies are similar to the sponsor company from an investment risk and expected investment return perspective. Guideline companies would fit into the same investment portfolio of companies as the sponsor companies. That is, investors would expect the same rates of return and variability of returns for all of these companies. However, the guideline companies would not necessarily “look like” the sponsor company.

Guideline company pricing multiples are more difficult for the valuation analyst to apply to the

sponsor company. Typically, it is not reasonable to assume that mean or median pricing multiples would automatically apply to the sponsor company. This is because the selected companies are not directly comparable to the sponsor company.

However, the analyst can compare the sponsor company to the guideline companies in terms of factors such as (1) relative growth rates, (2) relative profit margins, and (3) relative returns on investment.

From these comparative analyses, the analyst can extract pricing multiples to apply to the sponsor company financial fundamentals.

The GPTCM is based on the analyst’s considerations of guideline companies that trade on the national and regional stock exchanges. Those trading prices and pricing multiples are typically based on relatively small trades (say, a few thousand shares per trade) of very liquid securities.

The GMATM is based on the analyst’s assessment of recent mergers and acquisitions of entire companies in the sponsor company industry. Therefore, these transaction prices and pricing multiples are typically based on what a strategic buyer is willing to pay to get control of an overall business enterprise.

The backsolve method looks at historical sales of stock in the subject sponsor company. In other words, the analyst investigates actual, arm’s-length sales of sponsor company stock and then develops pricing multiples from those transactions.

Such transactions typically represent sales of small blocks of stock in very illiquid (sponsor company) securities. Based on the pricing multiples indicated by the recent sale transactions, the analyst “backsolves” the value of the sponsor company overall business.

As indicated above, the different market approach valuation methods could all conclude value indications based on a different level of value. The adjustments related to level of value are summarized later in this discussion.

Asset Approach

The asset approach (also called the asset-based approach) is based on the principle that the sponsor company equity value is equal to:

$$\begin{aligned} & \text{the value of the sponsor company assets} \\ & \quad \text{less} \\ & \text{the value of the sponsor company liabilities} \end{aligned}$$

The asset approach is used less frequently (than the income approach or the market approach) in

the valuation of employer corporation securities for these reasons:

1. It is more time consuming and, therefore, more expensive to perform.
2. Many ESOP valuation analysts do not have the experience or expertise required to value individual assets and liabilities.
3. Many ESOP valuation analysts are uninformed or misinformed regarding the application of this valuation approach.

However, the asset approach is particularly applicable in the following circumstances:

1. The sponsor company is either capital asset intensive or intangible asset intensive; that is, the value of the sponsor company relates directly to the value of its tangible assets or its intangible assets
2. The sponsor company is either a relatively new company or has experienced a recent period of negative operating results; therefore, the market approach and the income approach may understate the value of the sponsor company.
3. The ESOP trustee or the stock acquisition financing source wants to know the debt collateral value of the sponsor company assets.
4. The ESOP trustee or the financing source wants to know the post-financing solvency of the sponsor company.
5. Any party wants to know what the post-transaction sponsor company fair value balance sheet will look like if the ESOP stock purchase results in a change of control; such a change in control may trigger the fair value purchase accounting requirements.
6. The ESOP participants want to know exactly why they are being asked to pay a multiple of earnings or a multiple of book value for the sponsor company; in other words, what operating assets are the ESOP buying in the employer stock purchase transaction?

In order to perform an asset approach valuation, the analyst has to identify and value the following categories of assets and liabilities:

1. Net working capital (e.g., accounts receivable and inventory)
2. Tangible personal property (e.g., machinery and equipment)
3. Real estate (e.g., land and buildings)

4. Identified intangible assets (e.g., patents, copyrights, trademarks, licenses and permits, computer software, customer relationships)
5. Intangible value in the nature of goodwill
6. Contingent liabilities
7. Recorded liabilities

And, to correct the misinformation that many ESOP valuation analysts believe, the asset approach does not do the following:

1. Conclude a liquidation value in the sponsor company; rather, all of the tangible and intangible assets are valued on a value in continued use/going concern basis, so the concluded business value is a going concern value
2. Consider tangible assets only; rather, in most successful sponsor companies, most of the business value relates to identified intangible asset value and to goodwill
3. Rely on speculative values for intangible assets; rather, these values are exactly the same fair values that would be recorded on audited GAAP financial statements as the result of a purchase price allocation
4. Result in the net book value conclusion as reported in the sponsor company balance sheet; rather, a pre-fair value balance sheet and a post-fair value balance sheet bear little relationship to each other (except for the name of the sponsor company)

The common asset approach valuation methods include the following:

1. The asset accumulation method
2. The adjusted net asset value method

The typical asset approach valuation formula is summarized as follows:

$$\begin{aligned} & \text{Working capital value} \\ + & \text{ Tangible assets value} \\ + & \text{ Intangible assets value} \\ = & \text{ Total assets value} \\ - & \text{ Recorded liabilities value} \\ - & \text{ Contingent liabilities value} \\ = & \text{ Sponsor company equity value} \end{aligned}$$

Therefore, in addition to valuing the sponsor company intangible assets, the analyst has to also identify and quantify any sponsor company off-

balance-sheet contingent liabilities. Such liabilities include lawsuits, environmental concerns, and so forth.

Typically, the asset approach will indicate the sponsor company total equity value on a marketable, controlling interest level of value.

Valuation Synthesis and Conclusion

At this stage of the employer stock valuation, the analyst will typically adjust all of the value indications to be on the same level of value. Then, the analyst will synthesize (i.e., weight) the income, market, and (if performed) asset approach value indications in order to reach one final value conclusion for the sponsor company business.

This weighting is typically based on the analyst's assessment of the following:

1. The quantity and quality of available data
2. The applicability of each approach to the sponsor company
3. The range and reasonableness of the various value indication

To simplify this discussion, let's assume that the analyst has now concluded the sponsor company total common equity value. In practice, there is typically an intermediate procedure. That is, the analyst first concludes the sponsor company invested capital value.

From this invested capital value, the analyst subtracts the sponsor company long-term interest-bearing debt. This calculation results in the total equity value.

From this total equity value amount, the analyst subtracts the value of any sponsor company preferred stock to conclude a preliminary common equity value. The analyst finally adjusts the total common equity value for the proceeds from any in-the-money stock options.

The analyst then concludes the final total equity value (and the number of sponsor company outstanding shares that include exercised in-the-money options).

This above-described procedure is typically called the waterfall analysis. And, let's assume the valuation analyst completed the waterfall analysis for the sponsor company and estimated the total common equity value.

LEVELS OF VALUE

The term level of value relates to two investment criteria regarding to the employer stock:

1. Marketable versus nonmarketable—this criterion indicates how easy it is for the stockholder to sell the employer shares and convert that stock investment into cash.
2. Control versus lack of control—this criterion relates to how much control the employer stock shareholder has over the sponsor company business operations and strategic direction.

Many ESOP valuation analysts believe that there are only three separate and independent levels of value:

1. A marketable, controlling ownership interest (e.g., one stockholder owns 100% of the employer corporation)
2. A marketable, noncontrolling ownership interest (e.g., as if the employer corporation stock was publicly traded on a stock exchange)
3. A nonmarketable, noncontrolling ownership interest (e.g., the stockholder owns a small block of stock in the private employer corporation)

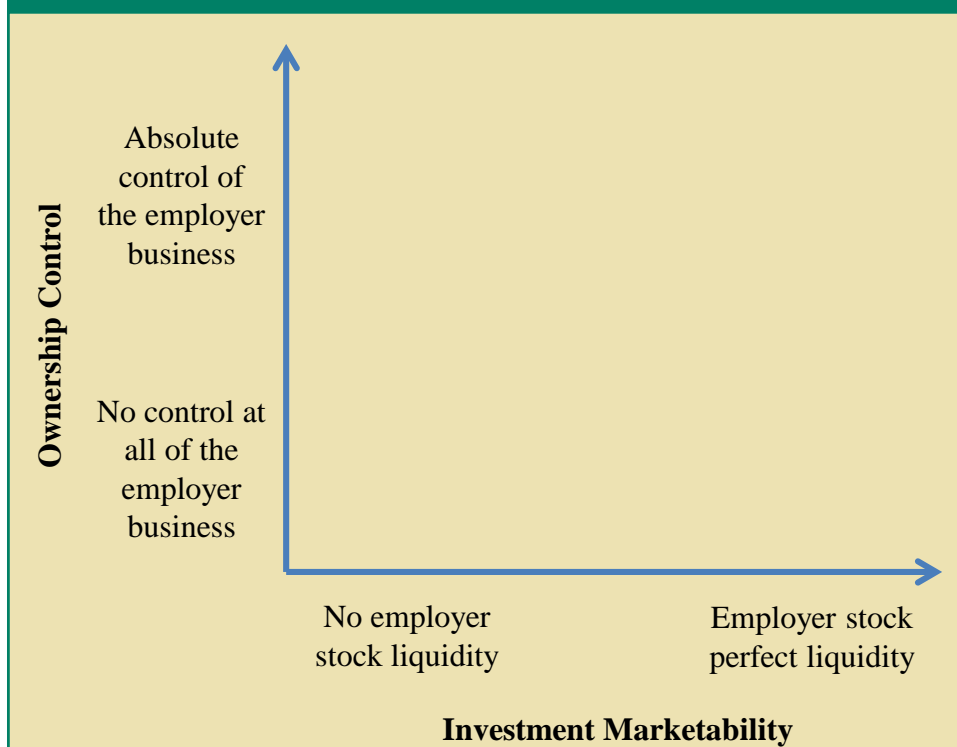
In fact, the above-listed levels of value represent an over-simplification. For all sponsor companies, these two investment criteria each exist on a continuum, not as discrete points on a graph.

Figure 1 more accurately reflects the level of value considerations that the investment analyst should assess with regard to the sponsor company stock:

Where the subject (i.e., ESOP transaction) employer stock falls in this X axis and Y axis continuum is a function of the following factors:

1. The absolute size of the subject stock block
2. The relative size of the subject stock block (compared to other stockholders)
3. The relative voting rights and policies of the sponsor company
4. The state in which the sponsor company is incorporated
5. The absolute number of board of directors and the rotation of board elections
6. The potential for a corporate liquidity event (e.g., IPO, stock tender offer, etc.)
7. The ability of the plan participant to put his/her shares back to the sponsor company
8. The contractual rights of the ESOP-owned stock block (such as come-along rights, tag-along rights, rights of first refusal, registration rights, etc.)

Figure 1
Sponsor Company Common Stock
Levels of Value



9. The history of private transactions in the sponsor company stock
10. The age, investment, retirement, estate, and other plans of the sponsor company's other major shareholders

As mentioned above, the valuation analyst will adjust all of the business value indications to be on the same level of value. Then, the valuation analyst will adjust that level of value to be consistent with the level that describes the actual marketability and control attributes of the ESOP transaction employer stock.

CONTRACTUAL RIGHTS AND PRIVILEGES

In addition to their effect on the employer stock marketability and control attributes, some contractual rights and privileges can separately (and materially) affect the value of the ESOP transaction employer stock.

The analyst should ensure that the value increment associated with contractual rights is not double-counted (i.e., both considered as a marketability/control attribute and then added again as a contrac-

tual attribute). However, the analyst should also ensure that the full value increment related to these contractual attributes is considered in the employer stock valuation.

It is noteworthy that this contractual rights value increment should be considered even if the ESOP-purchased stock is not the only stock that enjoys that attribute. For example, there is still a value increment associated with dividend preferences and liquidation preferences, even if both the ESOP-owned stock and the key executive-owned stock both enjoy those preferences.

The following list presents some of the common contractual rights and privileges that the valuation analyst should consider in the valuation of the ESOP-owned employer stock:

1. Dividend and liquidation preferences
2. Mandatory redemption rights
3. Preemptive rights
4. Conversion and participation rights
5. Antidilution rights
6. Registration rights
7. Voting rights
8. Protective provisions and veto rights
9. Board participation rights
10. Drag-along rights
11. Right to participate in future equity offerings
12. Right of first refusal in future equity offerings
13. Management rights
14. Access to information rights
15. Tag-along rights

Each of the above contractual rights may relate to a particular class of sponsor company equity. More commonly, these particular rights and privileges may only relate, by contract, to a particular block of employer stock.

For example, that block of employer stock may be the stock sold to the ESOP, the stock granted to identified senior executives, or the stock retained

by certain members of the sponsor company founding family.

Each of these contractual rights and privileges has an economic value. And, that economic value should be considered in the allocation of the overall sponsor company business value to that particular block of stock.

HOW THE ESOP PURCHASE OF THE EMPLOYER STOCK IS FINANCED

Typically, the ESOP purchase of the employer corporation stock is financed by debt capital. This statement is true whether (1) the ESOP purchases a noncontrolling block of employer stock or (2) the ESOP purchases 100 percent of the employer corporation stock.

There are various structures through which the ESOP trust can finance the employer stock purchase. Some of the common financing structures include the following:

1. The ESOP borrows funds directly from a financial institution, in a so-called outside loan
2. The sponsor company borrows the funds from the financial institution and the ESOP borrows the funds from the sponsor company, through a so-called minor loan structure
3. The ESOP borrows some or all of the financing from the employer stock sellers (in a seller-financed transaction)

The structure of the employer stock acquisition financing (including debt term, interest rate, prepayment options, etc.) is important to the ESOP, of course. However, the structure of the employer stock purchase financing is not that important to the employer common stock valuation (i.e., pricing).

However, how the stock purchase financing will be paid off may be important to the employer stock valuation. This issue relates to who will repay the employer stock acquisition loan, which may be one of the following parties:

1. The sponsor company (directly or indirectly)
2. The ESOP (as a sponsor company shareholder)

A more technical way to consider this issue is: what is the source of cash to pay the employer

stock acquisition loan? The source may be one of the following:

1. Employer contributions (“contributions”) from the sponsor company
2. Profit distributions (“distributions”) from the sponsor company

In both instances, the cash transfers from the sponsor company to the ESOP (and, then from the ESOP to the bank, to repay the acquisition loan). However, the answer to the above question may affect the employer stock valuation.

This is because ESOP contributions are accounted for as an operating expense of the sponsor company, just like any other retirement plan contributions would be. The sponsor company records that expense, and that expense (like any other expense) reduces the profitability of the sponsor company. And, all other things (such as discount rates and capitalization rates) assumed equal, a sponsor company with lower profits will have a lower stock value.

In contrast, ESOP distributions are not accounted for as an operating expense of the sponsor company, just like any other profit distributions or dividends to shareholders. Distributions are the payment of the sponsor net profits to its stockholders.

Unlike contributions, distributions are not the payment of an employer expense that reduces sponsor company profits. That is, the payment of distributions does not affect the sponsor profitability. So, all other things (such as discount rates and capitalization rates) assumed equal, a sponsor company profit distribution does not affect the employer stock value.

Let’s assume the ESOP receives the sponsor distributions, and then the ESOP pays the bank in order to repay the stock acquisitions loan. However, this payment is just like any third-party investor who buys General Electric Company (GE) common stock on margin. When the investor pays back the stockbroker margin loan from the GE quarterly dividend payments, that margin loan repayment does not reduce the value of the GE stock.

To illustrate the effect of how the employer transfers funds to the ESOP, let’s consider two identical sponsor companies.

Beta Sponsor Company (“Beta”) transfers cash to the ESOP through contributions. Gamma Sponsor Company (“Gamma”) transfers cash to the ESOP through distributions. Both ESOPs borrowed the same employer stock acquisition loan, and both ESOPs make the same annual principal and inter-

Exhibit 1 Current Year Summary Income Statement

	Beta Sponsor Company	Gamma Sponsor Company
Earnings before interest and taxes and ESOP contributions	\$10,000,000	\$10,000,000
– ESOP contributions	<u>5,000,000</u>	<u>—</u>
Earnings before interest and taxes	5,000,000	10,000,000
– Interest on (non-ESOP) long-term debt	<u>3,000,000</u>	<u>3,000,000</u>
Pretax income	<u>\$2,000,000</u>	<u>\$7,000,000</u>
Distribution to the ESOP (based on 80% equity ownership)		<u>\$5,600,000</u>

est payments to the bank to repay those acquisition loans.

The current year summary financial statements for both sponsor companies are presented in Exhibit 1.

In both cases, let's assume that the sponsor company stock is owned 80 percent by an ESOP and 20 percent by senior management. In addition, to simplify the example, let's assume that each sponsor company is an S corporation for federal income tax purposes.

Of course, both Beta and Gamma would have reported identical income statements prior to the ESOP purchase of the employer stock. For that reason, in both cases, the ESOP would pay the same price (i.e., recognize the same fair market value) for the employer stock in the initial purchase of the sponsor company securities.

However, after the ESOP formation and the employer stock purchase, the structure for the stock acquisition loan may affect the employer stock valuation. Let's assume both the Beta and the Gamma ESOP need to service \$5,000,000 of annual debt service on the stock acquisition loan.

Beta transfers the cash to the Beta ESOP as an ESOP contribution (i.e., an expense). If Beta was a C corporation, such a cash transfer would make a great deal of sense. This is because the \$5,000,000 contribution would be a tax-deductible expense to Beta for federal income tax purposes. (This deduction assumes that Beta meets the payroll-related deduction limitations.)

Since Beta and Gamma are both S corporations, there is little value to the ESOP contribution tax deduction. In contrast, Gamma elects to not recognize the cash transfer as an ESOP contribution expense. This recognition increases the Gamma pretax income.

Since the Gamma ESOP owns 80 percent of the sponsor company stock, it will receive 80 percent of all shareholder distributions. Assuming all income is distributed in the above example, the ESOP would receive 80 percent of the shareholder distributions (i.e., more than enough cash to service the stock acquisition debt).

And, the non-ESOP shareholders (i.e., the senior management) would receive the remaining 20 percent of the profit distributions.

Unlike the Beta ESOP contributions, the Gamma profit distributions do not reduce the sponsor company income. And, unlike the Beta ESOP contributions, the Gamma ESOP distributions are not an economic burden on the non-ESOP shareholders.

Each Gamma shareholder receives a proportionate profit distribution. That Gamma shareholder can use that profit distribution to pay stock purchase debt (as the ESOP will) or not. In contrast, the Beta \$5,000,000 ESOP contribution will cost the non-ESOP shareholders \$1,000,000.

That is because of the \$5,000,000 reduction in the sponsor company income and the fact that non-ESOP executives own 20 percent of the Beta income.

How the ESOP pays the stock acquisition loan (either with contributions or with distributions) also impacts the effect of that stock acquisition debt on the sponsor company valuation.

Valuation analysts sometimes value employer corporation stock using the direct equity method. That is, they value the common stock directly without reference to the sponsor company total enterprise value.

More frequently, valuation analysts value employer corporation stock using the invested capital method. That is, they value the employer corporation total enterprise (also called total invested capital). They then subtract the sponsor company long-term debt. And, finally, they subtract any sponsor company preferred stock in order to conclude a residual value for the sponsor company common stock. As mentioned above, this residual valuation procedure is often called the "waterfall procedure."

A sponsor company has two categories of long-term debt recorded on its balance sheets. First, the sponsor company notes payable and bonds payable are recorded as long-term debt. These liabilities represent funds borrowed by the sponsor company that (1) are used by the sponsor company and (2) the sponsor company is committed to pay back.

Second, under generally accepted accounting principles (GAAP), the sponsor company also has to record the ESOP employer stock acquisition debt as long-term debt on its balance sheet. The GAAP requirement applies even when the ESOP borrowed the funds directly from a third-party bank.

This GAAP requirement is appropriate because the sponsor company invariably guarantees the ESOP debt. That is, if the ESOP does not pay off the stock purchase loan, then the bank will look to the sponsor company to make good on the loan.

With regard to the employer stock value, the valuation analyst will always subtract the sponsor's long-term debt from the invested capital value in order to conclude the employer stock value.

And, the valuation analyst will typically subtract the ESOP debt recorded in the sponsor company balance sheet from the invested capital value in order to conclude the employer stock value. This is because most sponsor companies make contributions to the ESOP, and the ESOP pays off the debt from these contributions.

As explained above, ESOP contributions (1) reduce the employer stock value and (2) are shared proportionately by all of the sponsor company shareholders through their percentage of employer stock ownership. All C corporation and many S corporation sponsor companies use contributions to fund the ESOP debt service payments.

Therefore, the employer stock value is affected by the following:

1. How the sponsor company distributes funds to the ESOP for debt service purposes
2. How the ESOP receives the debt service funds from the sponsor company (relative to all of the other employer corporation shareholders)

The following discussion relates to the valuation factors that may be different in (1) employer stock sold to the ESOP versus (2) employer stock sold to non-ESOP parties.

TRANSACTIONAL SCENARIOS

The valuation analyst, the sponsor company, the selling stockholders, and the ESOP trustee can

experience numerous scenarios in which employer stock is sold to both an ESOP and a non-ESOP. Such a transaction would occur when the ESOP (through its trustee) participates in an employer stock purchase/sale transaction at about the same time that a non-ESOP party also participates in an employer stock purchase/sale transaction.

In such scenarios, it is not uncommon that the two employer stock transactions take place at two different prices.

The following discussion summarizes the valuation analyst considerations related to the following types of employer stock transactional scenarios:

1. An initial ESOP formation, when the ESOP purchases sponsor company shares and special employees also purchase sponsor company shares
2. A secondary ESOP employer stock purchase, when both the ESOP and special employees purchase additional blocks of sponsor company shares
3. The ESOP does not buy employer shares in the current transaction; rather, only the special employees buy shares
4. The sale of employer shares only to a capital provider (e.g., a venture capital investor, a private equity investor, a merchant bank investor, etc.)
5. The sale of employer stock only to a sponsor company strategic partner (a key customer, a key supplier, an intellectual property licensor or licensee, etc.)
6. A sponsor company repurchase of its own stock from a non-ESOP party
7. The sale or other transfer of employer stock that does not involve either the ESOP or the sponsor company (e.g., non-ESOP shareholder gift, estate, charitable contribution, marital estate transfers)
8. Other contractual agreements between the sponsor company and special employees that do not include employer stock transfers (e.g., employment, noncompete, consultancy, board membership, intellectual property license, and other agreements)

In these above-listed scenarios, the valuation analyst (and the ESOP trustee) will likely have (1) one set of valuation considerations for transactions involving the ESOP and (2) a slightly different set of valuation considerations for transactions involving the non-ESOP party.

“Often, the selling stockholders may unilaterally offer a below-market stock price to the ESOP as a form of gratitude to the company employees or a reward for years of loyal service.”

For purposes of this discussion, the term “special employees” is synonymous with the term “key employee.” For purposes of this discussion, these are employees who (1) the sponsor company wants to retain and (2) are difficult to replace.

In addition to senior management, the special employees category could include skilled engineers, scientists, salesmen, production specialists, quality specialists, and so forth. And, for purposes of this

discussion, what makes this class of employees special is that management may grant these employees options, warrants, or rights with regard to the sponsor company stock.

As all ESOP practitioners are aware, ERISA provides that an ESOP may acquire employer stock “if such acquisition, sale or lease is for adequate consideration.” With regard to pricing the employer stock, ERISA defines adequate consideration as the “fair market value of the asset determined in good faith by the trustee or named fiduciary.”

These ERISA definitions mean that an ESOP may pay no more than a fair market value price for the employer stock. However, the ESOP can pay less than fair market value for the employer stock. The ESOP may be able to buy the employer stock for less than fair market value if the trustee negotiates a favorable deal with the sponsor company or selling stockholders.

Often, the selling stockholders may unilaterally offer a below-market stock price to the ESOP as (1) a form of gratitude to the company employees or (2) a reward for years of loyal service. This observation is sometimes presented as one explanation for why an ESOP may pay a different (in this case, lower) price for the employer stock than the non-ESOP shareholder pays.

There are also situations where the sponsor company or selling shareholders may sell the employer stock to non-ESOP shareholders for a below-market price. Such a situation often occurs when the sponsor company wants to attract, retain, or reward special employees.

In a leveraged employer stock purchase transaction, the financing items should be at least as favorable to the ESOP as they are to the other deal participants. However, just because the sponsor company

allows special employees to purchase employer stock at a favorable price, that decision does not make the sale transaction unfair to the ESOP.

FACTORS THAT AFFECT THE DIFFERENT VALUATION CONSIDERATIONS

There are a variety of reasons why the valuation analyst will apply different valuation considerations to an ESOP stock transaction as compared to a non-ESOP stock transaction. Several of these reasons are summarized below.

First, the sponsor company may perceive the ESOP stockholder and the non-ESOP stockholder differently. To the sponsor company, the ESOP is a relatively permanent company owner. Certainly, the ESOP is a long-term investor that will provide part of the permanent capital structure for the sponsor company.

In contrast, special employees, strategic partners, and certain capital providers are not long-term investors. The sponsor company wants to retain these parties, of course. And the sponsor company wants to compensate these parties for their services.

However, from the sponsor company perspective, the ESOP stockholder and the non-ESOP stockholder have (1) different investment time horizons and (2) different investment objectives.

Second, from the stockholder perspective, the ESOP and the non-ESOP party may perceive the sponsor company differently. The ESOP participants own the sponsor company. The ESOP provides retirement benefits to the plan participants, of course. But, the plan participants often seek long-term capital appreciation over short-term income.

Non-ESOP stockholders typically have a much more finite investment perspective. They typically plan for a specific exit event after five years (or some similar time period).

The non-ESOP party wants to be compensated for the services they provide (e.g., executive talent, capital, intellectual property.) during the period they provide that service. Then, they want liquidity.

Again, from the stockholder perspective, the ESOP stockholder and the non-ESOP stockholder have (1) different investment time horizons and (2) different investment objectives.

Third, the ESOP and the non-ESOP parties may be buying different classes of employer securities. Of course, the type of security will affect the employer stock valuation. For example, the ESOP may purchase the employer common stock and the

non-ESOP parties may purchase the employer preferred stock. In such a case, the special employee, remaining family stockholders, or capital sources may want to be (relatively) assured of periodic dividend distributions.

In some instances, the ESOP may purchase the employer preferred stock. This procedure sometimes happens when the sponsor company may run into contribution tax deduction limitations based on employee payroll levels.

In that case, the preferred stock is intended to provide more cash into the ESOP than the sponsor company could pay through annual plan contributions. Accordingly, the valuation will be affected by the type of employer security subject to analysis.

Fourth, the form of ownership may affect the value of the employer stock. The ESOP trust will typically purchase the employer stock in fee simple interest. That is, the title to the employer stock is transferred from the sponsor company (or from the selling stockholder) to the trust, subject any lien that the bank may have related to the stock acquisition loan.

In contrast, a non-ESOP party may receive only a fractional ownership interest in the employer stock. For example, the special employee may not actually receive the stock ownership. Rather, the employee may receive an option, warrant, grant, or right related to the employer stock. The employee or other non-ESOP party rights may vest over time.

This vesting may be a function of the term of employment, stock ownership, debt financing provided, or some other relationship with the sponsor company. And, therefore, unlike for the ESOP, such employer stock ownership rights may be forfeited if the sponsor company contractual relationship lapses.

Fifth, the employer security rights and privileges directly affect the value of the employer stock. This occurs when the ESOP and the non-ESOP party both acquire employer stock (perhaps of the same class) with different sets of rights and privileges. The valuation analyst will take these different rights into consideration in the relative valuations of the different employer stock ownerships.

For example, the ESOP and the non-ESOP party could each own employer stock with differing rights related to the following:

1. Voting versus nonvoting
2. Dividend and profit participation
3. Liquidation preferences and participation
4. Control of the sponsor company board or certain management decisions

5. Registration, transferability, or other liquidity even opportunities
6. Right of first refusal and preemptive right

Sixth, the expected term of the employer stock could affect the value of stock purchased by the ESOP compared to a non-ESOP party. The common stock typically purchased by the ESOP trust is usually perpetual term stock. That is, there is no plan for the ESOP trust to redeem the stock (other than the ERISA-required plan participant retirement put option).

Employer stock sold to a non-ESOP party may be issued with an expected finite term, such as 5 years or 10 years. After that term, the sponsor company may be able to call the stock. Or, after that term, the investor may be able to put the entire block of stock back to the employer corporation.

Seventh, the liquidity of any security typically affects the valuation of that security. As mentioned above, the ESOP participants enjoy an ERISA-required put option. That is, a plan participant of a certain age can put the employer shares in his or her account back to either the ESOP or the sponsor company (depending on the plan terms).

Over a specified pay-out period, the sponsor company must buy back the employer shares at a price based on the valuation analyst's employer stock fair market value conclusion. Therefore, the employer shares in the plan participant accounts have a certain degree of liquidity.

At least when the employee reaches a certain retirement-related age, the employee can put the employer stock to the sponsor company. Unless there are contractual or other agreements in place, the non-ESOP shareholder may not have this liquidity expectation.

Eighth, the share vesting and allocation period may be different for the ESOP stockholder compared to the non-ESOP stockholder. The ESOP participant will expect the purchased employer shares to be allocated to his or her account as the following events occur:

1. The stock acquisition loan is paid by the ESOP
2. Contributions and distributions are made by the sponsor company to the ESOP

As mentioned above, the non-ESOP party may experience a much different vesting (and, effectively, allocation) period. For the non-ESOP party, the employer shares may be transferred from the sponsor company as the employee provides management,

noncompetition, joint venture, financing, or other services.

Ninth, the expectation of a liquidity event is different for the ESOP compared to the non-ESOP investor. The ESOP investors may give very little consideration to a liquidity event in their employer stock purchase decision. Their investment objective is to buy and hold the employer stock. ESOP participants generally view themselves as the permanent owners of the sponsor company.

Typically, their only consideration of a liquidity event is a company-wide liquidity event. Such a liquidity event would include an IPO or the overall acquisition of the sponsor company.

In contrast, the non-ESOP investor typically plans for a specific, short-term liquidity event. And, for the non-ESOP investor, the liquidity event is typically a contractual event and not a control event.

That is, the non-ESOP party may expect to sell the employer stock back to the sponsor company after the terms of an employment, noncompete, intellectual property license, debt indenture, or other contract expires. In contrast, the ESOP expects to be able to (at least) influence when a sponsor company IPO or an M&A transaction occurs.

Tenth, there may be a difference in the information disclosure rights available to the ESOP compared to the non-ESOP investor. The ESOP trustee receives the employer stock independent valuation report each year. That employer stock valuation includes the following:

1. Historical and current sponsor company financial statements
2. A current company, industry, and strategic analysis
3. Projections of future results of operations (typically)

Therefore, the ESOP trustee receives a fair amount of sponsor company financial and operational information. Most closely held companies are not very forthcoming with such company-specific information.

In contrast, unless they have specific contractual rights, the non-ESOP parties do not have access to the same sponsor company financial or valuation information. Even special employees (other than a CEO and CFO) may not have as much access to company-specific information as the ESOP trustee does.

Sponsor company financing sources may have contractual access to the company financial state-

ments, but they may not have access to the employer stock valuation reports.

Eleventh, the ESOP shareholders and the non-ESOP shareholders enjoy different levels of shareholder protection. The ESOP and the plan participants are protected by ERISA. The annual employer stock valuation must also comply with ERISA. In addition, the annual employer stock valuation is subject to contrarian review by the Internal Revenue Service and the U.S. Department of Labor.

In contrast, the non-ESOP party is not subject to ERISA protection. Rather, the non-ESOP party is only protected by any applicable state securities statutes. The non-ESOP party has no assurance that it can (1) purchase the employer stock for no more than fair market value and (2) sell the employer stock for no less than fair market value.

Rather, the non-ESOP party may only be able to negotiate the best price it can to buy or sell employer stock. And, that negotiated price may be higher or lower than fair market value.

Twelfth, the most significant difference between the ESOP and the non-ESOP stockholders may be the level of value issue. As described above, the level of value relates to the following two investment criteria:

1. Marketable versus nonmarketable interests
2. Controlling versus noncontrolling interests

The employer stock owned by the ESOP may represent a different level of value than the employer stock owned by the non-ESOP party. In fact, this situation will occur quite frequently. That is because two different shareholders cannot both own a controlling interest in the sponsor company.

If the ESOP owns a controlling interest, then the non-ESOP party does not own a controlling interest. And, if the non-ESOP party owns a controlling interest, then the ESOP does not own a controlling interest.

In addition, many ESOPs have contractual rights that allow the plan to acquire ownership control over a period of time. For example, the contract may allow the ESOP to continue to buy blocks of employer stock each year until it (1) owns control of the sponsor company or (2) owns 100 percent of the sponsor company.

In such a case, the ESOP is often treated as a control owner (and the employer stock purchase transaction is often treated as a control level transaction) for employer stock valuation purposes.

Also, as described above, there are numerous factors (contractual, regulatory, and otherwise) that affect the marketability of the ESOP-owned

employer stock compared to the non-ESOP owned employer stock. The valuation analyst should consider all of these factors in assessing where each block of sponsor company stock falls on the marketability continuum.

SUMMARY AND CONCLUSION

The experienced valuation analyst should understand that different fair market value estimates may be appropriate for the different blocks of sponsor company stock. And, the experienced valuation analyst should understand that there is even a valuation difference associated with whether the same size block of employer stock is owned by the ESOP or a non-ESOP party.

There are generally accepted valuation approaches and methods related to the valuation of the sponsor company. And, there are generally accepted considerations related to the valuation of ESOP-owned and non-ESOP owned employer stock.

These valuation considerations are different for the following reasons:

1. The ESOP and the non-ESOP party have different investment objectives and different investment time horizons.
2. The ESOP and the non-ESOP party securities may enjoy different rights and privileges (including ERISA-related rights).
3. The ESOP and the non-ESOP party may own employer stock at two different levels of value.
4. The ESOP-owned employer stock and the non-ESOP owned employer stock may be paid for from two fundamentally different levels of sponsor company cash flow (i.e., employer contributions that reduce the overall sponsor company value versus employer profit distributions that do not reduce the overall sponsor company value).

This last difference is particularly important for an S corporation sponsor company. For an S corporation, there is usually no income tax advantage to paying plan contribution versus shareholder profit distributions.

However, the employer stock valuation impact of this decision can be material. If the ESOP stock acquisition loan is repaid from employer contributions, then all sponsor company shareholders share in the cost of the ESOP stock purchase.

In contrast, if the ESOP stock acquisition loan is repaid from the sponsor profit distributions, then only the ESOP pays for the cost of the ESOP stock

purchase. In this situation, the non-ESOP stockholders do not subsidize the cost of the ESOP stock purchase through (1) reduced (after plan contribution expense) sponsor company profits and (2) reduced (due to lower profits) sponsor company stock values.

There are also a number of specific differences between ESOP-owned employer stock and non-ESOP owned employer stock. This discussion summarized many of those differences. The valuation analyst should consider each of these differences in the relative valuations of the employer stock (1) to the ESOP versus (2) to another party.

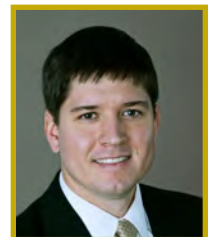
There are many different scenarios where a sponsor company may sell or otherwise transfer stock to the ESOP at a different price than to a non-ESOP party. This discussion summarized many of these scenarios. In these scenarios, the sponsor company (or the selling shareholders) sell stock to the ESOP, where the ESOP will serve as a long-term owner of the company's permanent capital base.

In contrast, the sponsor company (or the selling shareholders) may sell stock to other parties to attract, retain, or compensate key employees, suppliers, joint venturers, financing sources, and so forth.

The relationship between these parties and the sponsor company is fundamentally different than the relationship between the ESOP and the sponsor company. And, the investment criteria of these parties may be fundamentally different than the investment criteria of the ESOP.

The valuation analyst should consider all of these differences when estimating the fair market value of the employer stock to the ESOP compared to the investment value of the employer stock to any particular non-ESOP party.

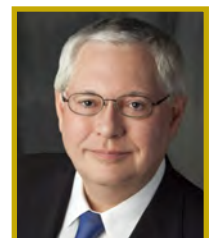
“... different fair market value estimates may be appropriate for the different blocks of sponsor company stock.”



Chip Brown, CPA, is a principal in our Atlanta office. Chip can be reached at (404) 475-2306 or at cbrown@willamette.com.



Steve Whittington is a manager in our Atlanta office. Steve can be reached at (404) 475-2317 or at scwhittington@willamette.com.



Robert F. Reilly, CPA, is a firm managing director and is resident in our Chicago office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.