

2023

ESOP VIRTUAL CONFERENCE

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ESOP Valuation Basics: How ESOP Valuations differ from Operating Company (T&E) Valuations

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Agenda – How ESOP Valuations Differ

- 1) Counterparties and Motivations
- 2) Standards of Value and Regulatory Environment
- 3) Value Basis / Discounts and Premiums
- 4) Common Structural Differences



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Counterparties and Motivation

Counterparties and Motivation

- T&E
 - Reduce tax burden
 - Charitable gift vs. family gift
 - Basis reset
 - Lifetime exemption
- ESOP: Annual Updates
 - Retirees would desire high value
 - New employees getting stock benefit from lower value
 - Volatility creates difficulty for RO planning

ESOP Transactions

- Valuation firm can be engaged by buyer or seller
- Negotiated transaction
 - Seller generally desires high value
 - Trustee/buyer can't pay more than fair market value
- Seller/owner can wear many hats
 - Also responsible for projections?
 - Represent interests of other shareholders?
 - Board/management roles?

ESOP Transaction – Typical Advisory Team

Sell-Side (Selling Shareholders/Company)

- Financial Advisor
- Law Firm (with ESOP experience)
- Accounting Firm
- Third Party Administration Firm
- Wealth Management Firm
- Communications Firm

Buy-Side (Trustee)

- Financial Advisor
- Law Firm

Potential Bias

- Risk Assessment
 - Management interview
 - Gain diverse perspective
 - Does characterization match market risk assessment
- Projection Bias
 - Who prepared projection?
 - Consider conflicts of interest
 - Test projection assumptions:
 - Industry estimates
 - Margins
 - Historical comparison and track record



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Standards of Value and Regulatory Environment

Fair Market Value for both T&E and ESOP

- T&E: Revenue Ruling 59-60

The price at which the property 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 have reasonable knowledge of the relevant facts

- ESOP: Adequate Consideration

...in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

- 1988 DOL Proposed Regulations

Standard of Value

- In both cases, Fair Market Value (FMV)
- Substantially similar definitions (Rev. Ruling 59-60/DOL Proposed Regs.)
 - Willing buyer/willing seller
 - Neither under compulsion to buy or sell
 - Both have knowledge of relevant facts
- While the same standard applies, there are still valid reasons the valuations can differ...

Is Fair Market Value tax-affected?

- Appraisals for both T&E (and ESOP) must wrestle with how to treat taxes
- Taxation of the ESOP company's earnings is dependent on the type of corporate entity and potentially the percentage of ownership held by the ESOP. How does this play into the valuation of ESOP shares annually?
 - Regular or C-Corporation tax considerations
 - Sub Chapter S-Corporation tax considerations
- S-Corp ESOPs are typically “valued as if” they were C Corporations under the FMV Standard and the hypothetical pool of Willing Buyers assumed

Adequate Consideration for ESOP Valuation

DOL Proposed Regulation Relating to the Definition of Adequate Consideration

- Released in 1988
- Never finalized by DOL under Section 408(e) of ERISA
- 2022 Secure 2.0 Act: Directs the DOL to provide formal guidance on valuation standards for determining fair market value
- April 2023: DOL communicates to The ESOP Association: Public notice and comment rulemaking on Adequate Consideration is forthcoming

Adequate Consideration for ESOP Valuation

- In the absence of *Regulation*, the DOL has attempted to influence ESOP Valuation through *Litigation*
- DOL Investigations
- Lawsuits against ESOP fiduciaries, claiming a breach of fiduciary duty and a claim that the price is paid for Company stock that is in excess of Adequate Consideration
- DOL has negotiated Process Agreements with multiple ESOP Trustees that influence ESOP Valuation

DOL Process Agreement with GreatBanc Trust

- GreatBanc, as trustee of the Sierra Aluminum ESOP, entered into a leveraged ESOP transaction with Company founders in 2006 to purchase stock
- The DOL filed suit in 2012 alleging GreatBanc's failure to engage in adequate diligence in several aspects for the transaction, including:
 - Failure to adequately investigate the Sierra financial statements, assumptions and projections, and
 - Failure to adequately investigate the valuation
- GreatBanc and the DOL agreed to and filed a Settlement Agreement with the court in 2014

DOL Process Agreement with GreatBanc Trust

- Greatest influence on Valuation relates to Financial Projections
- GB must identify individuals responsible for providing projections, and conduct reasonable inquiry as to:
 - whether those individuals have or reasonably may be determined to have any conflicts of interest in regard to the ESOP;
 - whether those individuals serve as agents or employees of persons with such conflicts, and the precise nature of any such conflicts; and
 - record in writing how the Trustee and the valuation advisor considered such conflicts in determining the value of employer securities

DOL Process Agreement with GreatBanc Trust

- Document in writing an opinion as to the reasonableness of any projections considered in connection with the proposed transaction and explain in writing why and to what extent the projections are or are not reasonable.
- Compare projections to company's five-year historical averages for the following metrics:
 - ROA
 - ROE
 - EBIT margins
 - EBITDA margins
 - Capital Expenditures to Sales
 - Revenue Growth Rate %
 - Free Cash Flows / Sales %



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Value Basis / Discounts and Premiums

Valuation of Control

- Where does FMV on a Control Basis end...
...And Strategic Value begin?
- DOL Scrutiny of Control Premiums applied to valuation methods

Valuation of Control

- Practical Implications on Income Approach / DCF Method
 - Control or Minority Cash Flows
 - Actual or Optimized Capital Structure
- Impact on Market Approaches
 - Discounts on Transaction Multiples to offset strategic premium
 - Premium / Discount on Guideline Public Company multiples

Elements of Control

- Is control, in form and substance, held by or passed to the ESOP?
- Reasonable to assume control will not be diluted within short time?
- How is Corporate Governance established to gain control in fact?
 - Composition of Board of Directors
 - Independent Directors
- Employment timeline (or retirement timeline) for selling shareholder(a)?

Minority Basis ownership by an ESOP

- More Common when ESOP established by Banks / former S&L's
- More Common when a 30% sale is the desired outcome
 - Capital Gain Deferral possible for C-Corp shareholders, 30%+ deal (Section 1042)
- Sometimes established as part of a plan towards 100% ESOP Ownership
- 1998: Establishment of S-Corp ESOP model
- Tax Advantages of 100% S-Corp ESOPs
- Implications on Valuation Methods and Approaches

Discount for Lack of Marketability

- Major area of difference between T&E and ESOP
- ESOP Plan obligation to repurchase Shares from employees
- Consider ESOP Plan “Put” rights (or right to receive cash)
- Consider ESOP sponsor’s ability to fund cash obligations



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Common Structural Differences

Use of Debt/Leverage

- T&E

- Commonly no or minimal debt
- Real estate or hard assets common collateral when borrowing

- ESOPs

- Leverage sources from transaction:
 - Senior debt/bank financing
 - Seller notes
 - Subordinated
 - Can have warrants and other features
 - Private equity/debt
 - Varied in complexity
- Internal ESOP debt

Succession/Management Planning

- T&E

- Likely managed by shareholders to some degree
 - Owner/managers don't likely require additional management plan or SARs
- Potential generation shift

- ESOPs

- Minority ESOPs may be managed by primary shareholders
- 100% ESOP may experience management transition to non-shareholders
 - Management incentive plan
 - SARs

C Corp/S Corp/LLC

- T&E
 - S Corp or LLC fairly common
- ESOPs
 - 100% ESOP
 - Likely S Corp, no tax distributions required
 - Minority ESOP
 - Could be S or C
 - C Corp could miss some tax benefits
 - S Corp requires tax distributions – can be some unintended consequences
 - LLCs can be used, but not typically direct ESOP ownership



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Q&A

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