

## ESOP Transaction Insights

## ESOP EMPLOYER STOCK PURCHASE TRANSACTION FAIRNESS OPINIONS

Malcolm ("Mike") R. Hartman

*ESOPs continue to be an attractive vehicle to allow closely held business owners to sell the company stock to the company employees. Today, almost all ESOP trustees require that their financial adviser prepare a fairness opinion related to the ESOP employer stock purchase transaction. This fairness opinion should state that the employer stock purchase transaction is fair to the ESOP from a financial point of view. This discussion presents a procedure checklist that may be considered by the financial adviser (1) in conducting the employer corporation stock valuation or (2) in performing any ESOP-related financial advisory due diligence analysis—such as the fairness opinion.*

### INTRODUCTION

An employer stock valuation is an important part of any transaction involving an employee stock ownership plan (ESOP). However, a fairness opinion is a much broader and a more inclusive opinion that covers all financial aspects of a proposed employer corporation capital transaction—including aspects related to the amount of "adequate consideration" that the ESOP can pay for the employer stock.

ESOP trustees very often require that the financial adviser go far beyond simply providing a valuation of the equity involved in a proposed transaction. Such requirements were not the case historically. Currently, an ESOP trustee may want an opinion saying that the proposed transaction is fair to the ESOP from a financial point of view.

This discussion is intended to describe the use of fairness opinions by ESOP trustees as a part of the approval process. This discussion considers:

1. the historical background on the use of ESOP fairness opinions,
2. the role of the independent financial adviser,
3. the elements of the fairness opinion, and
4. the contents of typical fairness presentations to an ESOP trustee.

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### A HISTORICAL PERSPECTIVE

Employee stock ownership plans became popular in the late 1980s, following the tax acts of 1984 and 1986. The Tax Reform Act of 1984 (Deficit Reduction Act of 1984) and the Tax Reform Act of 1986 both:

1. provided benefits for financial institutions that provided funding for ESOPs and
2. provided substantial tax benefits for both corporations that established an ESOP and company owners who sold stock to them.

Although the attributes of the ESOP structure became known in the financial services industry, the concept of transaction fairness developed over a number of years.

In the late 1980s, a number of ESOP transactions were completed without external independent trustees who were qualified and experienced in judging the fairness of corporate transactions.

In fact, it was commonplace for sponsor companies, even very large ones, to appoint company officers to serve in the role of ESOP trustee. In such transactions, no fairness opinion was requested or provided.

Typically, a valuation of the employer corporation securities would be completed and placed in the file without

much scrutiny or thought on the part of the sponsor company, its board, or its advisers.

Today, fairness opinions related to transactions involving ESOPs are serious business. ESOP trustees are almost always external and independent organizations that have the knowledge and experience to negotiate and close transactions that are in the best interest of the ESOP.

The ESOP trustees of today are relatively few in number. And, ESOP trustees require fairness opinions that serve the purpose of protecting the company and the ESOP from potential future claims by aggrieved parties. For this reason, there are relatively few knowledgeable ESOP financial advisers who are willing and qualified to provide transaction fairness opinions.

## THE ROLE OF THE INDEPENDENT FINANCIAL ADVISER

The responsibilities of the independent financial adviser in an ESOP employer corporation stock purchase/sale transaction are:

1. to analyze the subject sponsor company and
2. to estimate the fair market value of the employer corporation equity being sold.

As part of this process, the independent financial adviser is often asked to provide an opinion on the final transaction structure. The opinion to the ESOP trustee typically states that the ESOP is not paying more than adequate consideration for the stock that it is purchasing in the transaction, as required by the Employee Retirement Income Security Act of 1974 (ERISA).

This fairness opinion states that the transaction, in its entirety, is fair to the ESOP from a financial point of view. This fairness opinion goes beyond the price per share or the value of the stock being purchased.

The fairness opinion typically covers:

1. all elements of the proposed stock purchase/sale transaction,
2. the potential effect of the purchase/sale transaction on the ESOP, and
3. the financial treatment of all other parties to the purchase/sale transaction.

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*“The fair market value of the employer corporation stock is typically expressed to the ESOP trustee as a range of values and not as a specific value.”*

## THE ELEMENTS OF AN ESOP TRANSACTION FAIRNESS OPINION

The format and content of required ESOP fairness opinions may differ among professional ESOP trustees. However, all of them require the following elements in some form:

1. A determination of the fair market value of the sponsor company stock.

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 an compulsion to sell, both parties are able and willing to trade and are well informed about the asset and the market for the asset.

The fair market value of the employer corporation stock is typically expressed to the ESOP trustee as a range of values and not as a specific value. Such a range gives the ESOP trustee the ability to negotiate a price for the employer corporation stock depending on the particulars of the transaction.

2. A determination that the proposed transaction is fair to the ESOP relative to all other stakeholders who are party to the proposed transaction.

In virtually all ESOP formations today, the transaction constitutes more than simply a sale of shares of stock to an ESOP.

An ESOP trustee often requires that equity-based compensation plans be developed that reward key members of the management team for staying in place and for superior performance.

It is the responsibility of the ESOP trustee to determine whether or not these compensation plans are fair to the ESOP (i.e., not overly dilutive).

And, of course, the financial adviser should address this issue in the fairness opinion.

3. A determination that the terms of the financing of an ESOP transaction are market related and in the best interests of the ESOP.

For most ESOP transactions, loans are obtained from financial institutions and from selling shareholders.

The ESOP trustees typically take a close look at the terms of the loans to determine whether or not they are at least as favorable to the ESOP as would be the terms of comparable loans resulting from arm's-length

negotiations between independent parties, including the reasonableness of the interest rate.

It falls to the ESOP trustee's financial adviser:

- a. to make such determination and
- b. to present it to the trustee as a part of the fairness opinion.

Since many ESOP loans are made between a company and the bank with which it has a long standing relationship, this process is critical to the trustee.

4. Documentation of the process used by the company to obtain ESOP financing.

In addition to looking at the terms of ESOP financing, ESOP trustees will often ask the financial adviser to document what steps were taken to insure that the financing obtained for the transaction was negotiated and not simply imposed on the sponsor company by its long-time bankers.

Often, the ESOP trustee and its financial adviser will ask the sponsor company to present its financing arrangements to an alternative bank in order to make certain that the terms are, in fact, market related.

This is a relatively new development in the preparation of fairness opinions for ESOP transactions, but a development that ESOP trustees feel gives them an extra measure of comfort.

5. Analysis of the financial impact of the proposed transaction on the sponsor company.

Another relatively new ESOP fairness opinion requirement relates to what the financial impact of the proposed ESOP transaction will have on the sponsor company going forward. The ESOP financial adviser should convince the ESOP trustee that approving a specific transaction is in the financial interests of the employer corporation.

In order to assess the impact of the proposed stock purchase/sale transaction on the sponsor company, the financial adviser often completes scenario analyses. In these scenario analyses, worst case cash flow, as well as projected cash flow, are used. The ESOP trustee wants to know:

- a. that it is entering into a responsible transaction and
- b. that it has considered differing future scenarios.

## ESOP TRANSACTION FAIRNESS OPINION TRUSTEE FORMATS

Just as the depth and breadth of the fairness opinion work provided by the ESOP financial opinion has evolved over the years, so has the manner in which it is presented to the ESOP trustees. Today, most ESOP trustees consist of committees and not a single individual.

An ESOP trustee will have a committee that consists of individuals who have experience in stock valuation and financial analysis, benefit plan administration, and employee benefit law.

For this reason, ESOP financial advisory firms have developed presentation formats that are suitable for committees made up of individuals with varying backgrounds. A typical format would be a PowerPoint presentation, rather than a typical valuation report.

The fairness opinion itself is in letter format, is addressed to the ESOP trustee, and is signed by the financial advisory firm. It includes the conclusion reached by the financial adviser, a description of the work performed to reach that conclusion, and a listing of all of the documents reviewed and analyzed.

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The fairness opinion is the exclusive property of the ESOP trustee, and the fairness opinion can be relied upon only by the trustee.

It is noteworthy that the fairness opinion:

1. only relates to the facts and circumstances of the specific transaction,
2. is directed only to the ESOP, and
3. is only relevant on the date that it is issued.

While other parties to an ESOP transaction will invariably ask for a copy of it or even to be able to rely on it, this request is not granted by the knowledgeable ESOP trustee.

The presentation is submitted to the ESOP trustee prior to the time that the financial adviser makes a formal presentation to the committee, so that members will have an opportunity to read it thoroughly and prepare questions.

The presentation by the financial adviser is either in person or by conference call, depending on the preference of the trustee. Presentations tend to be formal in nature. Normally, the legal counsel to the trustee, an ESOP lawyer, will be present at such presentations.

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The PowerPoint presentation to the ESOP trustee often contains the following sections.

### Transaction Summary

This presentation section typically contains a complete description of the transaction, referencing the language in the stock purchase agreement and other transaction documents.

The ESOP trustee committee pays particular attention to this section. This is because the elements of the ESOP employer stock purchase/sale transaction are usually negotiated right up to the time of closing.

### Summary Conclusion

This section typically summarizes the conclusions reached by the ESOP financial adviser which will be discussed in detail in the presentation to the committee.

### Valuation Summary

A discussion of the valuation normally follows the summary conclusion section. It contains a description of the valuation methods used and the valuation results obtained.

There will typically be discussion of the valuation variables used in the discounted cash flow analysis, the guideline public company analysis, and the guideline transaction analysis. This section will also cover normalization adjustments that the financial adviser made to the employer corporation financial fundamentals (excess cash or working capital, etc.).

It will also include a section on other considerations where other elements of the valuation, such as post-transaction cash flow scenarios.

### Sponsor Company Overview

The sponsor company overview will typically describe the company in detail, including its organization, management team, the markets it serves, its products and services, and its history.

The sponsor company overview discussion will typically include both (1) an analysis of the risks of an equity investment in the subject business and (2) the financial adviser's assessment of those investment risks.

### Discussion of the Specific Industry

In this section, the financial adviser typically discusses the industry that the sponsor company participates in, and the

discussion focuses on the relative position of the sponsor company in that industry.

An important element of this section is information on the future of that particular industry derived from the research performed by the financial adviser.

### Discussion of the National and Local Economy in General

In this section, the financial adviser may discuss the national economy in general, giving consideration to growth rates, unemployment rates, costs of and access to capital, and other external factors that can affect the future of the business.

In addition, this section may include a discussion of economic factors for the specific sponsor company location.

### Appendices

The fairness opinion presentation is also likely to contain all or most of the following:

- a copy of the executed fairness opinion letter
- all of the relevant valuation exhibits
- descriptions of each of the guideline public companies used in the valuation work
- the valuation analyst's certification or representation
- a statement of contingent and limiting conditions
- the professional qualifications of the financial advisers who worked on the engagement

### CAVEATS FOR FINANCIAL ADVISERS REGARDING RELIANCE ON ANY PROCEDURAL CHECKLIST

It is important for any independent financial adviser to consider several caveats regarding the use of any checklist of due diligence procedures.

First, no checklist should ever substitute for the independent financial adviser's professional judgment.

Second, the checklist presented in Exhibit 1 is not intended to be a comprehensive and all-inclusive procedural list that should be followed without exception.

Third, the terminology (i.e., names of valuation methods and/or analytical procedures) used in the checklist presented in Exhibit 1 may have several interpretations.

Fourth, the facts and circumstances regarding a specific leveraged ESOP stock purchase transaction and a specific employer corporation should always be considered when determining the appropriateness of any procedure on any checklist.

Finally, the Exhibit 1 checklist should not be used to derive a “quantitative score” to evaluate the quality:

1. of a solvency analysis or
2. of a financial adviser’s solvency opinion.

For example, the fact that an individual due diligence analysis did not receive a “score” of 100 does not indicate that the analysis is not in compliance with promulgated regulations and recognized professional practices. Such an analysis may still be professionally competent, and it may be the appropriate basis for the financial adviser to assess adequate consideration.

Likewise, the fact that an individual due diligence analysis received a very high “score” does not necessarily indicate that the analysis was prepared in compliance with all promulgated regulations and recognized professional practices. Such a due diligence analysis may still be lacking in professional competence and may be an inadequate basis for the financial adviser to assess adequate consideration.

The checklist presented in Exhibit 1 is a tool that a financial adviser (or an ESOP trustee) can use as a procedural reminder in conducting and assessing an employer stock valuation or an ESOP financial advisory opinion.

The checklist may be used to document whether the requisite due diligence procedures were or were not performed. However, no checklist will evaluate the analytical quality and the professional judgment involved in the performance of the actual due diligence procedures.

The checklist presented in Exhibit 1 is not a substitute for the good faith, due diligence, prudence, and professional care of the financial adviser or the ESOP trustee.

Finally, the experienced ESOP financial adviser should understand that not all of the listed procedures are applicable (or even possible) for every due diligence analysis.

The professional judgment of the experienced ESOP financial adviser (and the practical realities of data

constraints, industry-specific practices, and so on) will determine which procedures are appropriate for each due diligence analysis.

## SUMMARY AND CONCLUSION

Fairness opinions related to ESOP employer stock purchase/sale transactions have evolved over the years to exacting assignments completed by experienced financial advisers and presented to increasingly knowledgeable and sophisticated ESOP trustees.

Early ESOP trustees did not realize that all of the fairness issues existed, and they relied on employer stock valuations that were often not reviewed. In contrast, today’s trustees require exacting analysis and thorough consideration of all of a proposed transaction’s elements.

This evolution has resulted in a small number of highly specialized trustee organizations and a small number of financial advisory firms with the knowledge and experience to serve them.

The Exhibit 1 checklist enumerates the due diligence procedures that are typically considered by an independent financial adviser in the preparation of an ESOP fairness opinion.

This Exhibit 1 Employer Stock Valuation and Financial Adviser Due Diligence Procedures checklist should serve as a useful tool to the independent financial adviser, the employer corporation management, the lender involved in the transaction financing, and the ESOP trustee.

The Exhibit 1 procedural checklist is intended to be applicable to the financial advisory due diligence analysis and the transaction fairness opinion.

However, this Employer Stock Valuation and Financial Adviser Due Diligence Procedures checklist should never be a substitute for the professional expertise and the reasoned judgment of the experienced ESOP independent financial adviser.

*“... no checklist will evaluate the analytical quality and the professional judgment involved in the performance of the actual due diligence procedures.”*

*“... today’s trustees require exacting analysis and thorough consideration of all of a proposed transactions’ elements.”*

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*Mike Hartman is a principal in our Atlanta office, and he directs the firm’s national ESOP practice. Mike can be reached at (404) 475-2311 or mhartman@willamette.com.*

**Exhibit 1**  
**Employer Stock Valuation and**  
**Financial Adviser Due Diligence Procedures**

| Analytical Procedures Typically Considered by an<br>Independent Financial Adviser in an Employer Corporation<br>Stock Valuation or Related Due Diligence Analysis   | Procedure<br>Performed by<br>the Financial<br>Adviser? |
|---|--|
| <u>I. Engagement Letter and/or Engagement Work Product</u>  |  |
| A. State the purpose and objective of the engagement  |  |
| 1. Identify the purpose of the analysis, or the reason to conduct the analysis (to issue a transactional fairness opinion, an employer corporation stock valuation, etc.)   | _____  |
| 2. Identify the objective of the analysis, that is, what the analysis is intended to do (e.g., to estimate the fair market value of a specified ESOP employer stock ownership interest, etc.)                               | _____  |
| B. Define the analysis assignment   |  |
| 1. Identify the party who retained the financial adviser (i.e., the client)   | _____  |
| 2. Identify the business entity and the specific security interest subject to analysis  | _____  |
| 3. Identify the form of the subject employer corporation (e.g., C corporation, S corporation, limited liability company, etc.)  | _____  |
| a. Indicate the state of incorporation  | _____  |
| b. Indicate the date of incorporation   | _____  |
| 4. Identify the specific employer corporation ownership or security subject to analysis   | _____  |
| 5. Identify the valuation date (i.e., the "as of" date of the analysis)   | _____  |
| C. Document the appropriate standard of value and the appropriate premise of value  |  |
| 1. Identify and define the appropriate standard, or definition, of value (e.g., fair market value or fair value)  | _____  |
| 2. Identify and define the appropriate premise of value—based on an analysis of the highest and best use of the subject employer corporation or security interest (e.g., value as a going concern, value in exchange, etc.) | _____  |
| <u>II. Due Diligence/Collection of Data</u>   |  |
| A. Collect and review employer corporation documents and information  |  |
| 1. Request historical financial information (typically, last five fiscal years financial statements and latest interim financial statements) including:   | _____  |
| a. Income statements  | _____  |
| b. Balance sheets   | _____  |
| c. Statements of cash flow  | _____  |
| d. Capital statements or statements of retained earnings  | _____  |
| e. Explanatory footnotes and supplemental disclosure to the financial statements  | _____  |
| 2. Request a list of employer corporation subsidiaries and/or financial ownership interest in other related companies   | _____  |
| a. Obtain relevant historical financial information the same as listed in item II.A.1. above  | _____  |
| b. Obtain a description of the business entities and interests, including the type of organization, the percentage of ownership, the original cost investment, and so on  | _____  |
| 3. Request other employer corporation financial information, including:   | _____  |
| a. All current financial budgets, projections, forecasts, or plans (prepared for any reason)  | _____  |
| b. Other financial schedules, prepared as of the valuation date (e.g., capital asset account balances, accumulated depreciation, inventory, accounts receivable, accounts payable, open orders, production backlog, etc.)   | _____  |
| c. Copies of all material employer corporation contracts/leases (e.g., employment agreements noncompete agreements, labor agreements, customer contracts, real estate leases, etc.)   | _____  |
| d. Amounts and description of employer corporation insurance in force (e.g., key person, property/casualty, business interruption, etc.)  | _____  |
| e. Compensation schedule for employer corporation senior management and employee/owners (e.g., salary, options, commissions, etc.)  | _____  |
| f. Copies of any prior employer corporation stock valuation and/or asset appraisal reports (prepared for any purpose during the past five years)  | _____  |
| g. Schedule of dividends declared and paid during the past five years   | _____  |
| 4. Request employer corporation legal documents, including:   | _____  |
| a. Articles of incorporation, by-laws, amendments to articles and by-laws, etc.   | _____  |

- b. Any existing employer corporation stock buy/sell agreements, options, rights of first refusal, etc. \_\_\_\_\_
- c. Minutes from recent employer corporation shareholders/meetings, typically covering the past two years \_\_\_\_\_
- d. List of all employer corporation shareholders \_\_\_\_\_
  - 1) ESOP-related loan agreements \_\_\_\_\_
  - 2) Number of shares owned by senior management \_\_\_\_\_
  - 3) Number of shares owned by employee/owners \_\_\_\_\_
- e. Descriptions of all recent prior transactions of the employer corporation stock and any recent bona fide offers to purchase the employer corporation and/or subject employer securities \_\_\_\_\_
- f. ESOP employer stock purchase/sale transaction document, including: \_\_\_\_\_
  - 1) ESOP-related loan agreements \_\_\_\_\_
  - 2) Employer stock purchase agreements \_\_\_\_\_
  - 3) ESOP plan and trust documents \_\_\_\_\_
  - 4) ESOP plan summary \_\_\_\_\_
  - 5) Any other documents that may affect the legal rights related to the ESOP-owned employer corporation securities \_\_\_\_\_
- 5. Request other relevant operational employer corporation information, including: \_\_\_\_\_
  - a. History (since inception) and current description of the employer corporation \_\_\_\_\_
  - b. Copies of all current employer corporation sales/marketing materials, brochures, advertisements, etc. \_\_\_\_\_
  - c. List of locations (owned or leased) in which the employer corporation operates \_\_\_\_\_
  - d. List of major customers by annual dollar volume \_\_\_\_\_
  - e. List of major suppliers by annual dollar volume \_\_\_\_\_
  - f. List of major competitors (including their size and/or market share, if available) \_\_\_\_\_
  - g. Breakdown of personnel (by department or by function) and resumes of senior management \_\_\_\_\_
  - h. Descriptions of all patents, trademarks, copyrights, and other owned or licensed intellectual properties \_\_\_\_\_
  - i. Description of any off-balance-sheet assets and contingent liabilities \_\_\_\_\_
  - j. List of related employer corporation industry or trade associations, related industry or trade publications, and memberships of the employer corporation \_\_\_\_\_
  - k. Description and current appraisals (if available) of all employer corporation nonoperating assets \_\_\_\_\_
  - l. Operational budgets, projections, plans, or forecasts (e.g., for production, sales, purchases, inventory, etc.) \_\_\_\_\_
- B. Conduct employer corporation management interviews \_\_\_\_\_
  - 1. Speak with employer corporation senior management in all relevant functional areas, regarding: \_\_\_\_\_
    - a. Historical operations and results \_\_\_\_\_
    - b. Prospective operations and results \_\_\_\_\_
    - c. Responsibility for functional areas \_\_\_\_\_
  - 2. Discuss with employer corporation senior management and/or outside legal counsel any pending potential litigation or claims, including: \_\_\_\_\_
    - a. Commercial litigation \_\_\_\_\_
    - b. Employment disputes \_\_\_\_\_
    - c. Occupational and safety issues \_\_\_\_\_
    - d. Environmental issues \_\_\_\_\_
    - e. Income or property tax disputes \_\_\_\_\_
    - f. Other matters \_\_\_\_\_
- C. Conduct employer corporation plant/site inspections \_\_\_\_\_
  - 1. Inspect representative plants and sites; consider: \_\_\_\_\_
    - a. Capacity limits and physical condition of existing plants, facilities, and equipment \_\_\_\_\_
    - b. Functional and technological adequacy (and/or obsolescence) \_\_\_\_\_
  - 2. Discuss plants and sites with employer corporation management representatives; consider: \_\_\_\_\_
    - a. Future facilities expansion and capital investment plans \_\_\_\_\_
    - b. Competitive effects of planned plant and facility changes \_\_\_\_\_
    - c. Expected operating cost effects of planned plant and facility changes \_\_\_\_\_

### III. Economic Environment (as of Valuation Date)

- A. Consider the national and international (if relevant) economic environment—research and analyze the national and international economic environment and outlook (as relevant) \_\_\_\_\_
- B. Consider the regional and local (if relevant) economic environment—research and analyze the regional and local economic environments and outlook (as relevant) \_\_\_\_\_
- C. Consider the historical and expected relationship of the relevant economic environment to the performance of the employer corporation—identify and quantify (if possible) significant relationships of the performance of the relevant economic environment with the performance of the employer corporation \_\_\_\_\_

### IV. Industry Environment (as of Valuation Date)

- A. Consider the industry in which the employer corporation operates—research and analyze the nature and history of the employer corporation industry \_\_\_\_\_
- B. Consider the current outlook for the employer corporation industry—research and analyze the current outlook for the employer corporation industry \_\_\_\_\_

### V. Fundamental Position of the Employer Corporation (as of Valuation Date)

- A. Analyze the employer corporation capitalization and ownership—analyze all classes of outstanding stock, including: \_\_\_\_\_
  - 1. Rights, seniority, voting, etc. of each class \_\_\_\_\_
  - 2. Total number of outstanding shares and percentage distribution of ownership of each class \_\_\_\_\_
- B. Consider the subject employer corporation history and operations: \_\_\_\_\_
  - 1. Review employer corporation history \_\_\_\_\_
  - 2. Review and analyze current employer corporation business operations, including: \_\_\_\_\_
    - a. Locations and markets served \_\_\_\_\_
    - b. Product lines, service lines, and customer base \_\_\_\_\_
    - c. Competition \_\_\_\_\_
      - 1) Current and projected market size \_\_\_\_\_
      - 2) Position of the employer corporation within the subject industry \_\_\_\_\_
      - 3) The employer corporation competitive strengths and weaknesses, both on an absolute basis and relative to competitors \_\_\_\_\_
    - d. Management and workforce \_\_\_\_\_
    - e. Overall positive and negative aspects of the employer corporation operations \_\_\_\_\_
    - f. Strengths, weaknesses, opportunities, and threats of the employer corporation, compared to the employer corporation industry in general and compared to direct competitors in particular \_\_\_\_\_
- C. Consider the outlook for the employer corporation—review current strategic plans, business projections, and the current business outlook \_\_\_\_\_

### VI. Financial Statement Normalization Adjustments and Analysis

- A. Make appropriate financial statement normalization adjustments, including: \_\_\_\_\_
  - 1. Adjust the value of inventory, as appropriate \_\_\_\_\_
    - a. LIFO vs. FIFO basis of inventory cost accounting \_\_\_\_\_
    - b. Inventory write-offs and/or write-downs, including assessment of reasons for shrinkage, obsolescence, etc. \_\_\_\_\_
  - 2. Adjust for excessive or insufficient shareholder/management compensation, as appropriate \_\_\_\_\_
  - 3. Adjust for nonrecurring financial statement items as appropriate, including: \_\_\_\_\_
    - a. Nonrecurring gains/losses, insurance proceeds, nonrecurring revenues, and/or expenses, etc. \_\_\_\_\_
    - b. Results of the effects of changes in accounting principles or methods \_\_\_\_\_
- B. Perform historical financial statement analysis \_\_\_\_\_
  - 1. Calculate and analyze common-size financial statements \_\_\_\_\_
  - 2. Compute and analyze financial and operating performance ratios, including: \_\_\_\_\_
    - a. Size ratios \_\_\_\_\_
    - b. Growth ratios \_\_\_\_\_
    - c. Liquidity ratios \_\_\_\_\_
    - d. Profitability ratios \_\_\_\_\_
    - e. Turnover/activity ratios \_\_\_\_\_
    - f. Leverage ratios \_\_\_\_\_
  - 3. Identify and explain any significant financial trends \_\_\_\_\_

- C. Perform prospective financial statement analysis \_\_\_\_\_
  - 1. Identify key financial variables (e.g., capacity constraints, cost/volume/profit relationships, etc) for prospective results of operations \_\_\_\_\_
  - 2. Obtain (if available) and analyze projections/budgets/forecast/plans for prospective results of operations \_\_\_\_\_
  - 3. Assess the reasonableness of employer corporation projections relative to historical employer corporation results of operations \_\_\_\_\_
  - 4. Assess the reasonableness of employer corporation projections relative to industry data \_\_\_\_\_

VII. Business/Security Valuation Analysis

- A. Consider and select appropriate business/security valuation approaches—identify and select appropriate valuation approaches (i.e., market approach, income approach, or asset-based approach) \_\_\_\_\_
- B. Perform a market approach—guideline company method, if appropriate \_\_\_\_\_
  - 1. Identify guideline publicly traded companies; consider: \_\_\_\_\_
    - a. Same or a similar line of business \_\_\_\_\_
    - b. Size \_\_\_\_\_
    - c. Trading activity/pricing evidence \_\_\_\_\_
    - d. Financial condition \_\_\_\_\_
  - 2. Normalize the financial statements of the guideline publicly traded companies (i.e., adjust guideline companies to make them more comparable to the employer corporation, that is, “apples to apples”) \_\_\_\_\_
  - 3. Identify appropriate financial and operating fundamentals \_\_\_\_\_
  - 4. Calculate market-derived pricing multiples for selected guideline publicly traded companies \_\_\_\_\_
  - 5. Analyze the range of market-derived guideline company valuation pricing multiples \_\_\_\_\_
    - a. Statistical analysis of range of valuation pricing multiples \_\_\_\_\_
    - b. Correlation of valuation pricing multiples with performance factors (e.g., growth rates, rates of return, profit margins, etc.) \_\_\_\_\_
  - 6. Compute and analyze financial and operating ratios for the selected guideline publicly traded companies, including: \_\_\_\_\_
    - a. Size ratios \_\_\_\_\_
    - b. Growth ratios \_\_\_\_\_
    - c. Liquidity ratios \_\_\_\_\_
    - d. Profitability ratios \_\_\_\_\_
    - e. Turnover/activity ratios \_\_\_\_\_
    - f. Leverage ratios \_\_\_\_\_
  - 7. Compare the employer corporation to the selected guideline publicly traded companies \_\_\_\_\_
  - 8. Select the appropriate market-derived valuation pricing multiples for the employer corporation \_\_\_\_\_
  - 9. Apply the selected valuation pricing multiples to the appropriate subject company financial and operating fundamentals \_\_\_\_\_
  - 10. Synthesize an estimate of value \_\_\_\_\_
    - a. Subtract the market value of employer corporation outstanding long-term debt if invested capital valuation analyses are used \_\_\_\_\_
    - b. Estimate a value of the employer corporation equity \_\_\_\_\_
  - 11. Identify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
  - 12. Quantify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
  - 13. Apply appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
- C. Perform a market approach—guideline merged and acquired company method, if appropriate \_\_\_\_\_
  - 1. Identify guideline merged or acquired companies/transaction, consider: \_\_\_\_\_
    - a. Same or a similar line of business \_\_\_\_\_
    - b. Size \_\_\_\_\_
    - c. Financial condition \_\_\_\_\_
    - d. Relevant time frame \_\_\_\_\_
    - e. Availability of pricing information \_\_\_\_\_

2. Normalize financial statements of the selected guideline merged and acquired companies (that is, adjust guideline companies to make them more comparable to the employer corporation, that is, "apples to apples") \_\_\_\_\_
3. Identify appropriate financial and operating fundamentals \_\_\_\_\_
4. Calculate transaction valuation pricing multiples for the selected guideline merged and acquired companies \_\_\_\_\_
5. Analyze the range of market-derived guideline company transaction valuation pricing multiples \_\_\_\_\_
  - a. Statistical analysis of range of valuation pricing multiples \_\_\_\_\_
  - b. Correlation of valuation pricing multiples with performance factors (growth rates, rates of return, profit margins, etc.) \_\_\_\_\_
6. Compute and analyze financial and operating ratios for the selected guideline merged and acquired companies, including: \_\_\_\_\_
  - a. Size ratios \_\_\_\_\_
  - b. Growth ratios \_\_\_\_\_
  - c. Liquidity ratios \_\_\_\_\_
  - d. Profitability ratios \_\_\_\_\_
  - e. Turnover/activity ratios \_\_\_\_\_
  - f. Leverage ratios \_\_\_\_\_
7. Compare the employer corporation to the guideline merged and acquired companies \_\_\_\_\_
8. Select the appropriate market-derived, transaction-based valuation pricing multiples for the employer corporation \_\_\_\_\_
9. Apply the selected valuation pricing multiples to the appropriate employer corporation earnings and operating fundamentals \_\_\_\_\_
10. Synthesize an estimate of value: Subtract the market value of employer corporation debt in invested capital valuation analyses \_\_\_\_\_
11. Identify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
12. Quantify appropriate valuation premiums/discounts (for the specific level of employer security to analysis) \_\_\_\_\_
13. Apply appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
- D. Perform an income approach—discounted economic income method, if appropriate \_\_\_\_\_
  1. Review and analyze financial projections related to prospective results of employer corporation operations for a relevant (e.g., five-year) discrete projection period \_\_\_\_\_
  2. Develop the appropriate economic income fundamentals for analysis, for example, net cash flow, which consider: \_\_\_\_\_
    - a. Earnings \_\_\_\_\_
    - b. Noncash expenditures (e.g., depreciation expense, amortization expense, etc.) \_\_\_\_\_
    - c. Capital expenditures \_\_\_\_\_
    - d. Net working capital requirements \_\_\_\_\_
  3. Develop the appropriate yield capitalization discount rate for the present value calculation with consideration to: \_\_\_\_\_
    - a. Current capital market investment and rate of return environment, including: \_\_\_\_\_
      - 1) Risk-free rates of return \_\_\_\_\_
      - 2) Equity rates of return (and/or equity risk premiums) \_\_\_\_\_
      - 3) Employer corporation-specific risks/required rates of return, with consideration to: \_\_\_\_\_
        - a) Expected attainability of employer corporation financial projections \_\_\_\_\_
        - b) Degree of employer corporation financial/operating leverage \_\_\_\_\_
        - c) Degree of diversification of the employer corporation business base \_\_\_\_\_
    - b. Capital structure \_\_\_\_\_
      - 1) Capital structure (i.e., mix of debt and equity components of invested capital) of the employer corporation \_\_\_\_\_
      - 2) Typical capital structure in the employer corporation subject industry \_\_\_\_\_
  4. Develop an estimate of the terminal/residual value, with consideration to: \_\_\_\_\_
    - a. Terminal/residual year financial fundamentals (e.g., net cash flow projection for terminal/residual year) \_\_\_\_\_

- b. Terminal/residual year direct capitalization rate (e.g., as derived from the Gordon dividend growth model) \_\_\_\_\_
  - 5. Apply the derived yield capitalization discount rate to the discrete period estimated economic income projection (e.g., net cash flow); include: \_\_\_\_\_
    - a. The discrete projection period of periodic economic income \_\_\_\_\_
    - b. The terminal/residual value estimate \_\_\_\_\_
  - 6. Calculate an estimate of value: Subtract the market value of employer corporation outstanding long-term if invested capital valuation analyses are used \_\_\_\_\_
  - 7. Identify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
  - 8. Quantify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
  - 9. Apply appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
- E. Perform an asset-based approach—adjusted net asset method, if appropriate \_\_\_\_\_
  - 1. Adjust all on-balance-sheet assets to current market value (including all current asset accounts, tangible asset accounts, investment accounts, etc.) \_\_\_\_\_
  - 2. Identify all off-balance-sheet intangible assets \_\_\_\_\_
  - 3. Estimate the fair market value of all off-balance-sheet intangible assets \_\_\_\_\_
  - 4. Estimate the fair market value of the total of all of the on-balance-sheets and off-balance sheet tangible and intangible assets \_\_\_\_\_
  - 5. Adjust all liability accounts to current market value (including consideration of any off-balance sheet and contingent liabilities) \_\_\_\_\_
  - 6. Calculate an estimate of the employer corporation total equity value as the fair market value of all assets (both tangible and intangible) less the fair market value of all liabilities (both recorded and contingent) \_\_\_\_\_
  - 7. Identify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
  - 8. Quantify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
  - 9. Apply appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis) \_\_\_\_\_
- F. Consider any other relevant business/security valuation approaches \_\_\_\_\_
  - 1. Consider the application of any alternative valuation approaches \_\_\_\_\_
  - 2. Perform the appropriate alternative valuation approach methods or document why such alternative approaches are not applicable \_\_\_\_\_
- G. Prepare a synthesis of value \_\_\_\_\_
  - 1. Determine the relevance of each of the respective valuation approaches used in the analysis \_\_\_\_\_
  - 2. Weight the alternative estimates of value \_\_\_\_\_
- H. Reach a conclusion of value—conclude the appropriate fair market value estimate for the employer corporation security \_\_\_\_\_

VIII. Reporting the Results of the Employer Corporation Valuation and ESOP Financial Advisory Service Due Diligence

- A. Prepare a transactional fairness opinion, as requested \_\_\_\_\_
  - 1. Describe the proposed employer corporation securities purchase transactions \_\_\_\_\_
  - 2. Analyze the proposed employer corporation securities purchase transaction in order to conclude whether the ESOP is paying no more for the employer securities than any other typical willing buyer would pay \_\_\_\_\_
  - 3. Opine on the fairness of the proposed employer corporation securities purchase transaction from a financial point of view, with consideration of the concluded fair market value of the employer securities. \_\_\_\_\_

IX. Documentation of the Employer Corporation Valuation and ESOP Financial Advisory Service Due Diligence

- A. Prepare engagement analysis work papers—prepare and maintain work papers and files that document the employer corporation valuation analysis and the ESOP financial advisory service due diligence \_\_\_\_\_
- B. Prepare a valuation opinion and/or a narrative valuation report \_\_\_\_\_
  - 1. Opine on the adequate consideration with regard to the employer corporation securities consistent with the Department of Labor proposed regulation \_\_\_\_\_

2. Opine on the fair market value of the employer corporation securities consistent with the Department of Labor proposed regulation \_\_\_\_\_
3. Prepare a narrative valuation report in compliance with the fair market value requirement of the Department of Labor proposed regulation contain the following information: \_\_\_\_\_
  - a. A summary of the qualification of the financial adviser to perform the valuation of the employer corporation securities \_\_\_\_\_
  - b. A statement of the employer corporation securities value, a statement of the methods used in estimating that value, and the reasons for the employer corporation securities value conclusion in light of those methods \_\_\_\_\_
  - c. A full description of the employer corporation securities being valued \_\_\_\_\_
  - d. The factors taken into account in making the valuation, including any restrictions, understandings, agreements or obligations limiting the use or disposition of the subject employer corporation securities \_\_\_\_\_
  - e. The purpose for which the employer corporation valuation was made \_\_\_\_\_
  - f. The relevance or significance accorded to the valuation methods taken into account \_\_\_\_\_
  - g. The effective date of the valuation \_\_\_\_\_
  - h. In cases where a valuation report has been prepared, the signature of the person making the valuation and the date the report was signed \_\_\_\_\_
4. Include in any written valuation report an assessment of the following factors, consistent with the Department of Labor proposed regulation: \_\_\_\_\_
  - a. The nature of the employer corporation and the history from its inception \_\_\_\_\_
  - b. The economic outlook in general and the condition and outlook of the employer corporation industry in particular \_\_\_\_\_
  - c. The book value of the employer corporation securities and the financial condition of the employer corporation \_\_\_\_\_
  - d. The earnings capacity of the employer corporation \_\_\_\_\_
  - e. The dividend-paying capacity of the employer corporation \_\_\_\_\_
  - f. Whether the employer corporation has goodwill or other intangible value \_\_\_\_\_
  - g. The market price of securities of corporations engaged in the same or similar line of business, which are actively traded in a free and open market \_\_\_\_\_
  - h. The marketability, or lack thereof, of the employer corporation securities \_\_\_\_\_
  - i. Whether the seller would be able to obtain an ownership control price premium with regard to the employer corporation securities; in cases where an ownership control price premium is added, confirm that: \_\_\_\_\_
    - 1) Actual control (both in form and in substance) is passed to the ESOP with the employer corporation stock sale (or will pass to the ESOP within a reasonable time) \_\_\_\_\_
    - 2) It is reasonable to assume that the ESOP ownership control will not be dissipated within a short period of time after the employer corporation stock purchase \_\_\_\_\_