The Role of the Valuation Analyst

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In an ESOP Formation Financial Feasibility Analysis (Part I of II)

This two-part article discusses ESOPs. Owners of a private company who are looking for an exit strategy may consider the sale of all (or part) of the company to an employee stock ownership plan (ESOP). Such a strategy may be particularly attractive to baby boomer private company owners who are seeking retirement and liquidity and who would prefer to see their loyal employees retain a stake in the company ownership. This article considers the role of the valuation analyst in performing an ESOP financial feasibility analysis. Such an analysis should help the private company owner to assess whether a sale of the company stock to an ESOP makes sense as an ownership transition strategy. In the second part of this article, the author focuses on quality of earnings, liquidity, and plan design analysis.

Resources:
ESOPs: Nuts & Bolts

ESOPs

ESOP Valuation Basics

Legal Considerations for ESOPs

Introduction

When it is time for the owners of a private company to consider an ownership transition (i.e., a sale of the company on the path to retirement), a sale to the company employees may be one option to consider. This particular ownership transition exit strategy is often implemented through the formation of an employee stock ownership plan (ESOP). The private company sponsors (i.e., arranges) the formation of the ESOP. And, the ESOP trust buys the private company stock, often through a leveraged stock acquisition transaction. As discussed below, the selling stockholders may or may not provide seller financing to make the stock acquisition transaction more attractive to the employees.

Through the ESOP purchase of the company stock, the selling stockholders receive liquidityâ□□usually in a tax-advanced structure. The selling stockholders achieve the ownership transition objective that they are seeking. And, the loyal employees enjoy a stake in the ownership of the private company on a going-forward basis.

Obviously, an ESOP formation and a leveraged stock acquisition is not the appropriate ownership transition strategy to satisfy every private company ownerâ□□s exit plan. This article discusses the factors that the current company shareholders should consider before the company sponsors an ESOP formation. And, this article describes the ESOP financial feasibility analysis that the valuation analyst (analyst) should perform before the current owners implement a sale of the company to an ESOP.

Before a private company proceeds with the formation of an ESOP, an analyst should perform an ESOP formation feasibility analysis. The purpose of a feasibility analysis is to give both the selling shareholder(s) and the company management/directors the information they need to determine whether to move forward with the ESOP formation and with the ESOPâ□□s purchase of the company stock.

The results of the feasibility analysis should enable the private company, the trustee of the to-be-formed ESOP trustee, the selling shareholder(s), and the legal counsel to all parties to structure a transaction that is beneficial to all parties. Of course, to comply with federal laws, such a stock purchase transaction must be fair to the to-be-formed ESOP from a financial point of view.

This discussion summarizes the analystâ□□s role in the ESOP financial feasibility analysis. And, this discussion summarizes how the parties to the ESOP formation may use the information developed by the analyst in the financial feasibility analysis to decide ifâ□□and howâ□□to structure the ownership transition transaction.

In the decision to implement an ESOP purchase of the company stock, the selling shareholders must consider whether (and at what price) to sell their shares to the ESOP. The selling shareholders also must decide whether they are willing to give up ownership control of the private company to a new ownerâ□□that is, to the ESOP. This transfer of ownership control consideration is also relevant in an ESOP formation where the company itself (and not the current shareholders) sells treasury shares to the ESOP.

The private company managers and directors have to consider whether the company can afford to finance the ESOP stock purchase transactionâ□□particularly if the ESOP transaction is to be a leveraged stock purchase. The company managers and directors also have to consider the other (nondebt service) ESOP-related costsâ□□such as plan administration expenses, regulatory compliance expenses, and financial statement impact â□□costs.â□□

The information developed by the analyst during the ESOP financial feasibility analysis allows these parties to decide whether or not an ESOP stock purchase transaction is an effective strategy for achieving the current shareholdersâ□□ ownership transition and liquidity objectives. Each ESOP feasibility analysis will be different depending on each companyâ□□s situation. However, most ESOP feasibility analyses include certain basic considerations in order to:

1. Provide meaningful information to all parties involved in the ESOP formation and company sale decision and
2. Avoid costly mistakes that could impair the long-term success of the ESOP (and of the company itself).

The ESOP Financial Feasibility Analysis

In general, the ESOP feasibility analysis should address the following transaction pricing and structuring questions:

- What parties will sell the private company shares to the to-be-formed ESOP?
- How will the to-be-formed ESOP finance the purchase of the private company stock?
- How will this new stock acquisition financing (if any) affect the cash flow of the company?
- What is the best plan design for the company? For example, should the company merge the to-be-formed ESOP with its existing 401(k) plan?
- What are the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (and state securities law) regulations related to an ESOP that the company management and the selling shareholder(s) should know about?
- What if the actual company future results of operations varyâ□□positively or negativelyâ□□from any financial projections prepared at the time of the company stock purchase transaction?
- How does the selling shareholdersâ□□ desired sale price for the company stock compare to the range of company stock fair market values estimated by the analyst working for the to-be-formed ESOP trustee?

Initial Considerations

The initial considerations regarding the ESOP feasibility analysis may be assessed by the companyâ□□s selling shareholder(s)â□□with the help of the company management. That is, the ESOP feasibility initial considerations may be determined without the need to retain an analyst or legal counsel.

In general, private companies that are reasonable candidates to successfully implement an ESOP formationâ□□and to sponsor a sustainable ESOPâ□□have the following characteristics:

- Be a private U.S. company
- Employ more than 50 full-time employees
- Have an established track record of consistent profitability and earnings growth
- Have at least 10 years of company operating history
- Report at least $20 million in company annual revenue
- Have one or more company owners who are interested in investment liquidity and in a diversification of their personal wealth
- Have one or more company owners who are interested in ownership/management succession planning and in the transition of the company ownership to the employees
- Have one or more owners who would consider accepting a reasonably conservative stock value (i.e., a price that is at the lower end of the range of or corporate acquirer transaction prices)
- Have a senior management team that supports the concept of an ESOP formation (and of the employee ownership of the private company)

The controlling shareholder(s) should assess the company relative to these benchmark characteristics in order to determine if the company is a reasonable candidate for an ESOP formation. This initial feasibility analysis may be performed internally within the companyâ□□that is, without the company having to spend large amounts of time and money.

That is, if the private company, the selling shareholders, and the company management do not â□□passâ□□ these threshold characteristic â□□tests,â□□ then the company may not be a particularly good candidate for an ESOP formation. The company stockholders and the company management do not need to proceed to the financial, valuation, or administrative â□□testsâ□□ associated with an ESOP formation.

The next procedure of the feasibility analysis is for the company shareholders and company management to become more familiar with the ESOP installation process. This procedure should include developing a familiarity with the financial, legal, administrative, and regulatory aspects of an ESOP formation. The ESOP Association and the National Center for Employee Ownership are useful resources for this type of information.

This â□□process familiarityâ□□ procedure should allow the parties in interest to address questions such as the following:

- Can the differing goals and objectives of the various company shareholdersâ□□and of the other parties to the proposed stock sale transaction (e.g., management team, employees, nonselling shareholders, etc.)â□□be achieved through the formation of an ESOP?
- Would a company merger or a sale to a strategic acquirerâ□□or some other type of company liquidity eventâ□□be better suited to achieve the objectives of the company shareholders, management, and other parties?

- What percentage of the company stock will the to-be-formed ESOP own after the stock purchase transaction? And, which shareholders will sell or redeem their shares as part of the ESOPâ□□s stock purchase transaction?
- How will the current company managementâ□□and the current controlling shareholder(s)â□□react to the inevitable changes in voting/control rights and in corporate governance?
- How will the companyâ□□s current management succession planning be addressed in relation to the stock ownership change transaction? How long will the selling shareholders (assuming they are also company managers or directors) remain in their current management roles? How will the successors to the current executive management or board of directors be identified and transitioned in order to maintain operational management continuity on a going-forward basis?
- Is it desirable for the company to merge the to-be-formed ESOP with the companyâ□□s existing 401(k)â□□or other employee benefitâ□□plan?
- What happens to any existing management incentive (compensation) plans? Will a new management compensation plan be introduced at the same time as the ESOP stock purchase transaction?
- Which of the companyâ□□s employees will (and will not) be eligible to participate in the to-be-formed ESOP?

Consideration of these questions may help to clarify the strategic objectives (and the personal objectives) of all interested parties to the private company ownership transition. In order for the ESOP formation to be successful, the analyst should evaluate the means of achieving these strategic objectives (and these personal objectives) as part of the ESOP feasibility analysis.

If these initial procedures indicate that financing an ESOP stock purchase transaction is a reasonable alternative for achieving the objectives of most of the interested parties, then it may be time for the company to retain experienced ESOP advisers. These ESOP advisers will address some of the more technical (and complex) ESOP formation feasibility issues. These ESOP advisers typically include a trustee, legal counsel, an analyst serving as an independent financial adviser, and perhaps others.

Typical Components of an ESOP Financial Feasibility Analysis

A comprehensive ESOP feasibility analysis typically includes several transaction planning, pricing, structuring, administrative, and legal considerations. These considerations typically include the following:

- A preliminary valuation of the private company stock to determine the approximate fair market value price that the to-be-formed ESOP could or may pay
- A quality of earnings (or stockholdersâ□□ equity) analysis to determine how the to-be-formed ESOP would affect 1) the existing company shareholders and 2) the companyâ□□s future financial performance
- A plan design study to determine the most beneficial stock ownership transition transaction structure and which plan features to incorporate in the to-be-formed ESOP
- A liquidity study to assess the future demands that the ESOP stock repurchase obligation may eventually make on the company

A Preliminary Valuation Analysis

A preliminary valuation analysis of the company stock is an important component of the ESOP financial feasibility analysis. It is one of the procedures that should be performed early in the process. Accordingly, this preliminary valuation analysis may be performed by an analyst without undertaking a comprehensive due diligence investigation.

Therefore, the analyst typically cannot provide a final opinion of the fair market value of the private company. Rather, the analyst provides an opinion of a reasonableâ□□but not finalâ□□range of fair market value indications for the company stock.

The estimation of the company stock value is a complex processâ□□and it is important to the ESOP formation decision. Accordingly, the parties usually retain an analyst who is experienced in ESOPâ□□and ERISA-relatedâ□□stock valuations.

In fact, typically the selling shareholders (and/or the company) and the trustee to the to-be-formed ESOP typically each retain their own analyst at this stage of the feasibility analysis. Regardless of whether the analyst is retained by the companyâ□□s selling shareholders or by the to-be-formed ESOP trustee, the analystâ□□s preliminary value conclusion is typically expressed as a range of fair market values for the private company stock.

At this stage of the feasibility analysis, an analyst experienced in ESOPâ□□or ERISA-relatedâ□□stock valuations will typically estimate a reasonable range of stock values without preparing a narrative valuation report. Consequently, the expense associated with this preliminary valuation analysis is usually less than the expense associated with the analystâ□□s final stock valuation analysis (and the preparation of a written narrative valuation report).

The estimation of the preliminary range of company stock fair market values is often considered on the â□□critical pathâ□□ of the ESOP formation process. It is important for all the parties to find out early if:

- The preliminary stock value range is less than the per-share stock price desired by the companyâ□□s selling stockholders and
- Structuring alternatives, such as earn-outs or warrants, cannot be used to encourage the companyâ□□s selling stockholders to accept the preliminary stock price.

In such an instance, other strategies may have to be considered to increase the ownership transition attractiveness to the companyâ□□s selling shareholders. Such â□□otherâ□□ strategies may include waiting until the companyâ□□s financial performance improves, reducing company operating expenses, and the like. In other words, what can the selling shareholders do to increase the value (i.e., the selling price) of the private company?

If the companyâ□□s principal shareholders are not willing to sell their stock to the ESOP, or to permit the company to issue new shares of stock at a price within the preliminary range of fair market values estimated by the analyst, then the ESOP formation process may be abandoned.

Therefore, the preliminary range of fair market values for the company stock should be concluded as early as possible in the ESOP feasibility process. That way, the selling shareholders can change direction and evaluate other liquidity alternativesâ□□while still minimizing the expense incurred to pursue an ESOP formation strategy that will ultimately be unsuccessful.

In the second of this two-part article, the author focuses on quality of earnings analysis, liquidity analysis, and plan design analysis.

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