The Role of the Valuation Analyst

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

This is the second of two-part article that discusses ESOPs. In this part, the author focuses on quality of earnings, liquidity, and plan design analyses. 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.

Resources:
ESOPs: Nuts & Bolts

ESOPs

ESOP Valuation Basics

Legal Considerations for ESOPs

This is the second of the two-part article on ESOP Formation Financial Feasibility Analysis. Read Part I here.

The Quality of Earnings Analysis

The following components of the financial feasibility analysis can all be performed concurrently:

- The quality of earnings analysis (which includes what is often called a stockholdersâ□□ equity analysis)
- The company liquidity (or cash flow test) study
- The ESOP design study

In fact, these financial and administrative analyses can be performed at the same time that the preliminary stock valuation analysis is being performed.

In the quality of earnings analyses, the analyst should address several of the important questions that are typically asked by the companyâ□□s principal shareholders. These principal shareholders are typically interested in the following considerations, particularly for the time period during which the ESOP stock purchase loan will be outstanding:

- How will the ESOP affect the fair market value of their (retained) stock ownership?
- How will the ESOP affect the companyâ□□s expected cash flow and the companyâ□□s expected profitability?
- What dilution effect will the ESOP-owned shares have on the company stock fair market value?

If the company already has an existing pension and/or profit-sharing plan, the quality of earnings analysis may also compare:

1. The effects of the ESOP stock ownership in contrast to
2. The effects on the stock ownership (without the ESOP formation) of the existing plans.

The quality of earnings analysis typically applies management-prepared financial projectionsâ□□projections with alternative growth rate and profitability assumptions and other ESOP transaction variablesâ□□to create several alternative scenarios. The analyst performs this scenario analysis to illustrate the resulting impact of the to-be-formed ESOP on (1) the company cash flow and (2) the company stock value.

The cash flow component of the quality of earnings analysis can also be used as a structuring tool to help evaluate a mixture of stock purchase financing options. The alternative ESOP stock purchase financing options may include varying levels of bank debt financing versus seller note financingâ□□as well as the assorted terms and conditions of the proposed financing structure.

In the quality of earnings analysis, some of the analysis variables that are typically adjusted (or â□□stress testedâ□□) in order to construct alternative scenarios include the following:

- Revenue growth rates
- Profit margins
- Amounts of the company operations-related bank financing

- Amounts ofâ□□and terms ofâ□□the ESOP stock purchase bank financing
- The ESOP stock purchase bank financing terms (interest rates, covenants, maturity, required prepayments, guarantees, etc.)
- Amounts of any selling stockholder-provided financing
- Any selling stockholder subordinated debt terms (interest rates, maturity, required prepayments, warrants, etc.)
- The refinancing of the companyâ□□s existing bank debt
- Any expected future capital expenditure investment requirements
- Any expected future working capital investment requirements

Often, the analyst applies the management-prepared financial projections as a â□□base caseâ□□ scenario in the quality of earnings analysis. The analyst then adjusts (or â□□stress testsâ□□) the revenue, expense, investment, and income projection variables in order to create alternative financial projected scenarios. These alternative scenarios may include financial projections that reflect prospective operations under optimistic, pessimistic, and zero growth conditions.

These alternative scenarios typically hold all of the other company operational variables constant across the various sets of conditions. The goal of stress testing the operational variables in these alternative scenarios is to illustrate how the private company could fare under alternative future operating circumstances.

Liquidity Analysis

The liquidity analysis component of the ESOP feasibility analysis is intended to estimate the amount of the ESOP stock repurchase obligation that the company may incur over the next, say, 10 to 15 years. This ESOP stock repurchase obligation results from the employeesâ□□ expected future terminations of service due to death, disability, retirement, and so forth.

The liquidity analysis typically does not address the source of funding for the ESOP stock repurchase obligation. Nonetheless, this liquidity analysis is a valuable tool that can help the company management to estimate the timing ofâ□□and the amount ofâ□□the funding that may be needed in the future for repurchasing the allocated shares from any departing employees.

This information allows the company management to make the appropriate financing, insurance, or other liquidity plans.

Plan Design Study Analysis

The greater the flexibility included into the design of the ESOP documents themselves, the more effectively the ESOP will be able to accomplish its objectives.

The ESOP design study will typically address the following issues:

- Plan participant eligibility
- Employee vesting schedules
- Timing of the benefit distributions

- Forfeitures of departing employees
- Company contribution levels
- Employee account allocation formulas
- Past service credit
- Early retirement policies
- A corporate charter or bylaw provision that restricts the stock ownership to the employee group

The use of one or more special classes of stock (e.g., nonvoting stock, preferred or convertible preferred stock, etc.) may also be addressed in the ESOP plan design study.

Some of the other questions that may need to be considered in the ESOP plan design study include the following:

- Who will (and will not) be able to participate in the to-be-formed ESOP?
- Must the company distribute the shares of stock to employees at retirementâ□□or at other required distribution datesâ□□if the employees demand it, or can the company just limit the form of the distributions to cash?
- What company divisions or subsidiaries may be excluded from the plan?
- Who will (and who will not) be able to vote the shares of the ESOP-owned company stockâ□□and under what circumstances?
- Should the company combine other benefit plans, such as a 401(k) plan, with the ESOP?
- What will happen to the companyâ□□s existing pension or profit-sharing plan?
- Is the existing company pension plan overfunded, underfunded, or adequately funded?
- What about the selection of the ESOP fiduciary/trustee, and of any possible administrative and/or advisory committee(s)?

The consideration of income tax issues should also be part of the plan design phase of an ESOP feasibility analysis. The relevant income-tax-related issues may include the tax implications of ESOP-related legislation, regulations and administrative rulings, and judicial precedent.

In addition, all of the interested parties should consider the implications of the following issues:

- The â□□tax-deferred reinvestmentâ□□ or â□□tax-free rolloverâ□□ election available for the selling shareholders with regard to the sale proceeds of the company stock to an ESOP
- The tax deductibility to the company of dividend payments if paid to the ESOP participants or used to repay the ESOP stock purchase loan
- Compliance considerations for an S corporation company that will be owned by an ESOP
- Any new or currently proposed tax regulations or legislation

If a deferred profit sharing or money purchase pension plan already exists at the company, it is normally â□□frozen.â□□ The assets of the existing benefit plan will typically remain invested in a diversified portfolio of publicly traded securities. However, the employees can be given the option to invest a portionâ□□or allâ□□of their assets from a profit sharing, money purchase, or 401(k) plan into either (1) the company stock or (2) part of the ESOP stock purchase transaction.

Almost all ESOP sponsor companies either maintain or establish a diversified 401(k) plan that is not invested in the company stock. However, in some cases, the company may decide to merge its existing 401(k) plan with the newly formed ESOP.

In these situations, employees who are invested in the companyâ□□s 401(k) plan are given the opportunity to invest their money into the ESOP. These funds are considered part of the stock purchase transaction financing. These funds are used to purchase the companyâ□□s shares from the selling shareholder(s).

All federal and state securities laws should be complied with, and â□□full disclosureâ□□ should be provided to the company employees. Full disclosure can be a fairly burdensome requirement for a private company.

As mentioned above, there are both expenses and risks associated with a new ESOP formation. For example, the private company that forms an ESOP will be required to create a disclosure memorandum.

The disclosure memorandum typically describes the following:

- The nature of the companyâ□□s business operations
- The companyâ□□s historical financial performance
- Managementâ□□s expectations for the companyâ□□s future financial performance
- The risks associated with investing in the company stock
- Other information that an investor may require in order to make an informed investment decision

The disclosure memorandum is then distributed to the company employees. The employees are typically given 20 to 30 days to make their decisions about investing in the company stock. The distribution of this disclosure memorandum may be considered a risk to the ESOP formation process. This is because, often, the company employees may not have the financial sophisticationâ□□or the desireâ□□to evaluate all the information provided in the disclosure memorandum.

Therefore, some employees may simply elect not to invest in the company stock. As a result, the company may not receive the level of employee participation that was expected for the ESOP formation.

In some cases, the company may make financial advisers available at no cost to the employees. These financial advisers may be provided to give the company employees the resources they need to make an informed investment decision. However, due to the expense associated with giving employees the option to invest their 401(k) or profit-sharing assets in the company stock, the company management should carefully weigh the risks versus the probability of success before pursuing this option.

If the company management determines that this option will be pursued, then a temporary â□□floor priceâ□□ is usually attached to the company stock acquired with assets from other benefit plans. This temporary floor price often remains in effect until the ESOPâ□□s stock purchase loan is completely repaid.

In most cases, this â□□floor priceâ□□ is calculated as the fair market value of the company stock without considering the impact of the ESOPâ□□s stock purchase loan.

The ESOP plan design features should also allow for factors that will positively influence employee motivation. For example, an accelerated vesting schedule may serve to motivate employee participation in the ESOP. However, as a means to prevent vested employees from terminating their employment prematurely in order to receive large account balances, the ESOP sponsor company may postpone the distribution of accounts to terminated employees for a certain time period.

The transfer of voting rights is also a concern for many shareholders of a private company. However, this issue has not actually resulted in a problem for ESOP-owned sponsor companies. The requirement to â□□pass throughâ□□ voting rights to employees of private sponsor companies is a function of state law.

However, the voting rights â□□pass throughâ□□ is usually only required for major corporate issues such as mergers, consolidations, recapitalizations, sale of the business, liquidation, dissolutions, and similar types of transactions.

When a trusted, experienced management team has a proven track record of successfully operating the business to achieve growth and profitability, the employees are generally content to not be involved in the management of the ESOP sponsor company.

Summary and Conclusion

Upon the completion of the ESOP financial feasibility analysis, the analyst typically presents the findings to the private companyâ□□s board of directors or to an ESOP formation committee. That committee may include board, management, and employee representatives.

The group of professionals involved in conducting the ESOP financial feasibility analysis may include the analyst, an ESOP consultant, investment bankers, lenders, the senior management team, legal counsel, and the companyâ□□s selling shareholders. It is important for all of these parties to (1) anticipate potential ESOP formation obstacles and (2) have reasonable solutions to each of these obstacles.

Based on such anticipatory consideration, any last-minute obstacles or issues can be evaluated as part of the decision-making process of the private companyâ□□s board of directors and of the ESOP formation committee.

Further, the evaluation of the ESOP feasibility is an ongoing part of the ESOP formation process. As valuation, structuring, and financing decisions are made, circumstances (both for the company and for the selling shareholders) may change. In such instances, various alternative ownership transition opportunities may be considered.

As the consideration of the company sale transaction proceeds, the different aspects and considerations of the ESOP financial feasibility analysis should be updated. This updated analysis should reflect the most current set of facts related to the private companyâ□□in order to confirm the continued financial feasibility of the ESOP formation.

Finally, the decision to enter into a transaction to buy the companyâ□□s shares and to pay a fair market value price for those company shares is made (on behalf of the to-be-formed ESOP participants) by the ESOP fiduciary.

For private company owners considering a sale of all (or part) of the company, an ESOP formation is one possible ownership transition structure. An analyst will typically perform a comprehensive ESOP formation and financial feasibility analysis in order to assess whether the sale of the company stock to the ESOP makes sense to the selling shareholders, to the to-be-formed ESOP employee participants, and to the company itself.

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