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# Valuing the Employee Purchase of Employer Company Stock—Part II

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*Editor's Note: The previous installment of this series summarized the generally accepted valuation approaches related to the employee purchase of employer company stock. This installment summarizes the impact of security-specific contractual rights and privileges on the employer stock valuation.*

## Contractual Rights and Privileges

Some contractual rights and privileges can separately (and materially) impact the stock value in an employee stock purchase, as well as have an effect on the stock marketability and control attributes. The valuation 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 contractual attribute).

The analyst should also ensure that the full value increment related to these contractual attributes be considered in the stock valuation. And, it is noteworthy that this value increment should be considered even if the block of stock subject to the employee purchase 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 stock owned by all employees and the stock owned by key executives both enjoy those preferences.

The following list presents some of the common contractual rights and privileges that the valuation analyst should consider in the employee purchase valuation of the employer company 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; and
15. Tag-along rights.

Each of the above-listed contractual rights may relate to a particular class of employer company equity. More commonly, these particular rights and privileges may only relate, by contract, to a particular block of the company stock. For example, that block of stock may be the stock sold to the general employee group, the stock granted to identified senior executives, or the stock retained by certain members of the company founding family. Each of these contractual rights and privileges has a value. And, that value should be considered in the allocation of the overall company business value to each specific block of stock.

**Table 1** summarizes the purposes of the above-listed contractual rights from the perspective of an employee group that is purchasing the company stock.

A more detailed description of these contractual rights and privileges was presented in an earlier *Business Valuation Alert* article, "Summary of Contractual Rights and Privileges That Affect the Company Stock Value," published in April 2012.

## How the Employee Stock Purchase Will be Financed

Typically, the employee purchase of the company stock is financed by debt capital. This statement is true whether (1) the employees purchase a noncontrolling block of company stock or (2) the employees purchase 100 percent of the company stock. There are various structures through which the

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employee buyout group can finance the subject company stock purchase. Some of the common financing structures include the following:

1. The employee buyout group borrows funds directly from a financial institution.
2. The employee buyout group borrows funds from the subject company.
3. The employee borrows some or all of the financing from the subject company sellers (in a seller-financed transaction).

In all of these cases, there is typically some equity component to the employee buyout of the subject company. That equity component can come from (1) the employees generally, (2) the management group, or (3) a private equity fund (or similar investor).

The structure of the company stock acquisition financing (including debt term, interest rate, prepayment options, etc.) is important to the employee acquirers, of course. This is because the structure of the company stock purchase financing can be important to the valuation (i.e., pricing) of the company common stock.

Several components of the acquisition debt structuring could affect the stock purchase transaction. For example, the longer the term of the acquisition loan, the less amount of cash the subject company will have to distribute each year for debt service payments. The lower the amount of the acquisition loan, the smaller the amount of the subject company assets that may be encumbered as debt collateral. That will free up other company assets to use as collateral for expansion (instead of acquisition) financing.

The lower the acquisition debt interest rate, the lower the company weighted average cost of capital. All else being equal, the greater the amount of the purchase price financed by debt, the lower the company cost of capital. This is because, typically, the cost of debt capital is lower than the corresponding cost of equity capital. In addition, for most taxpayers, investment-related interest expense is tax deductible. So, the after tax cost of debt is less than the before tax cost of debt. In contrast, the "cost" of an equity investment is not tax deductible.

Particularly with regard to seller-financed stock acquisitions, the sellers may be inclined to offer a below market interest rate on the seller financing. This below-market interest rate feature could greatly reduce the effective price of the subject company stock purchase.

For example, let's consider the employee buyout of 100 percent of the stock of Epsilon Company ("Epsilon"). All parties agree that the Epsilon stock has a total fair market value of $100 million. The employees (through management and private equity investors) pay $20 million in equity. The Epsilon sellers provide seller financing for the remaining $80 million of the total stock price.

Let's assume that the current market interest rate on a ten-year term note with annual amortization is 8 percent. If the embedded (i.e., stated) interest rate on the seller notes is 8 percent, then the value of the seller notes is $80 million, of course. In total, the employees will pay $100 million for the company stock (i.e., $20 million in equity and $80 million in debt).

In comparison, let's assume that the sellers offer the employee buyout group ten-year notes with annual amortization and an

## TABLE 1

### Partial List of Rights and Privileges That Affect Company Stock Value

| Nature of the Contractual Right | Purpose of the Contractual Right |
|---|---|
| Preferred dividends (noncumulative | Preference to receive dividends, if declared |
| Preferred dividends (cumulative) | Aims to provide a minimum fixed return in all situations except for an IPO |
| Liquidation preference (nonparticipating) | Ensures higher return up until the "breakeven point" |
| Liquidation preference (participating) | Ensures disproportionately higher return in all situations except for an IPO |
| Mandatory redemption | Right to a return of capital; aims to provide liquidity |
| Conversion (based on either a fixed or a variable ratio) | Produces better economic results, in certain circumstances |
| Antidilution | Aims to protect the value of the stock investment |
| Registration | Aims to provide investment liquidity |
| Voting | Ability to control or influence the company operations |
| Protective provisions and veto rights | Ability to control disproportionate that is to ownership |
| Board composition | Ability to control disproportionate that is to ownership |
| Drag-along | Ability to control disproportionate that is to ownership |
| Right to participate in future equity offerings | Ability to maintain current ownership percentage |
| Right of first refusal | Restricted ability to sell the subject common stock |
| Tag-along | Restricted ability to sell the subject common stock |
| Management access | Access to inside information not available to other stockholders |
| Information access | Access to inside information not available to other stockholders |

embedded (i.e., stated) interest rate of 6 percent. In this case, the market value of the $80 million notes is only $72.9 million. Therefore, due to the below-market interest rate favorable financing, the employees will pay $92.9 in total for the $100 million stock price of the subject company. This simplified example illustrates the impact of the stock acquisition financing on the value of an employee stock purchase transaction.

## Subject Company Stock Purchase Transactions

This discussion relates to the valuation factors that may vary depending on the stock purchase transaction structure.

The valuation analyst, the subject company, the selling stockholders, and the employee buyout group can experience numerous scenarios in which a stock sale to both the employees and an individual party occur simultaneously. Such a transaction would occur when the employees participate in a company stock purchase transaction at about the same time that a special party also participates in a subject company stock purchase/transaction. In such scenarios, it is not uncommon that the two company stock transactions takes place at two different prices.

Here, we summarize the valuation analyst considerations related to the following types of company stock transaction scenarios:

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

In these scenarios, the valuation analyst may have (1) one set of valuation considerations for transactions involving the employee buyout group and (2) a slightly different set of valuation considerations for transactions involving the special employee or non-employee party.

For purposes of this discussion, the term "special employee" is synonymous with the term "key employee." In this discussion, special employees are employees that (1) the company particularly wants to retain and (2) are particularly difficult to replace. In addition to senior management, the special employee category could include skilled engineers, scientists, salesmen, production specialists, quality specialists, etc. What makes this class of employee special is that management may grant special employees options, warrants, or rights with regard to the subject company stock.

There may be situations when the sellers may unilaterally offer a below-market stock price to the employee buyout group as a form of gratitude to the company employees or a reward for years of loyal service. This observation is presented simply as one explanation for why the employee buyout group may pay a different (in this case, lower) price for the company stock than the non-employer shareholder pays.

There may also situations where the subject company or the sellers may sell the stock to non-management shareholders for a below-market price. Such a situation may occur when the subject company wants to attract, retain, or reward special employees. Just because the subject company allows special employees to purchase company stock at a favorable price, that decision does not make the sale transaction unfair to the company employee buyout group.

## Factors that Affect the Different Valuation Considerations

There are a variety of reasons why the valuation analyst may apply different valuation considerations to a employee stock purchase transaction as compared to a non-employee stock purchase transaction. Twelve of these reasons are summarized below.

**1. The subject company will typically perceive the employee stockholders and the non-employee stockholders differently.** To the company, the employee buyout group is a relatively permanent company owner. Certainly, the employee buyout group is a long-term investor that will provide part of the permanent capital structure for the subject company. In contrast, special employees, strategic partners, and certain capital providers are not long-term investors. The subject company wants to retain these parties, of course. And the company wants to compensate these parties for their services. However, from the company perspective, the employee stockholders and the non-employee stockholders have (1) different investment time horizons and (2) different investment objectives.

**2. From the stockholder perspective, the employee buyout group and the non-employee party may perceive the com-**

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**pany differently.** Let's assume that the employee buyout group will own all or most of the company. Typically, the employee buyout group seeks long-term capital appreciation over short-term income. Non-employee 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-employee parties want to be compensated for the services they provide (e.g., executive talent, capital, intellectual property, etc.) during the period they provide that service. Then, they want liquidity. Again, from the stockholder perspective, the employee buyout group and the non-employee stockholder have (1) different investment time horizons and (2) different investment objectives.

**3. The employee buyout group and the non-employee parties may buy different classes of company securities.** Of course, the type of security will affect the company stock valuation. For example, the employee buyout group may purchase the subject company common stock. And, the non-employee parties may purchase the company 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 employee buyout group may also purchase the company preferred stock. In any event, the valuation will be affected by the type of subject company security to analysis.

**4. The form of ownership may affect the value of the company stock.** The employee buyout group will typically purchase the company stock in fee simple interest. That is, the title to the stock is transferred from the subject company (or from the selling stockholder) to the employee buyout group subject any lien that a bank may have related to a stock acquisition loan. In contrast, a non-employee party may receive only a fractional ownership interest in the subject stock. For example, the special employee may not actually receive the stock ownership. Rather, the special employee may receive an option, warrant, grant, or right related to the subject stock. The special employee or the non-employee 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 subject company. And, therefore, unlike for the employee buyout group, such company stock ownership rights may be forfeited if the company contractual relationship lapses.

**5. As described previously, the company stock rights and privileges directly affect the value of the subject stock.** This occurs when the employee buyout group and the non-employee party both acquire company 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 company stock ownerships. For example, the employee buyout group and the non-employee party could each own company stock with differing rights related to:

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; and
6. Right of first refusal and preemptive right.

**6. The expected term of the company stock may affect the value of stock purchased by the employee buyout group compared to the stock purchased by a non-employee party.** The common stock typically purchased by the employee buyout group is usually perpetual term stock. That is, there is no plan for the employee buyout group to redeem the stock. Company stock sold to a non-employee party may be issued with an expected finite term, such as 5 years or 10 years. After that term, the subject company may be able to call the stock. Or, after that term, the non-employee investor may be able to put the entire block of stock back to the company.

**7. The future obligation of the employee owners is often different than that of the non-employee stockholders.** Once the employee buyout group consummates the stock purchase transaction, the employees typically have no further obligation. They do not have to continue to be employees of the subject company in order to continue owning the company shares. These employees may or may not have the right to put their stock back to the company when they leave the employment of that company. In contrast, the non-employee owners typically need to continue to provide services (e.g., executive management, joint venture, financing, etc.) in order for them to continue to own the company stock.

**8. The subject company stock vesting and allocation period may be different for the employee buyout group compared to the non-employee stockholder.** The employee buyout group member will expect the purchased company shares to be allocated to him or her as the stock acquisition loan is paid down and the lien on the shares is released by the lending institution. As mentioned above, the non-employee party may experience a much different vesting (and, effectively, allocation) period. For the non-employee party, the company shares may be transferred from the subject company only after the party provides executive management, noncompetition, joint venture, financing, or other services.

**9. The expectation of a liquidity event is different for the employee buyout group compared to the non-employee investor.** The employee buyout group investors may give very little consideration to a liquidity event in their subject company

stock purchase decision. Their investment objective is to buy and hold the subject company stock. Employee buyout group members generally view themselves as the permanent owners of the 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 acquisition of the company.

In contrast, the non-employee investor typically plans for a specific, short-term liquidity event. And, for the non-employee investor, the liquidity event is typically a contractual event and not a control event. That is, the non-employee party may expect to sell the company stock back to the subject company after the terms of an employment, noncompete, intellectual property license, debt indenture, or other contract expires. In contrast, the employee buyout group expects to be able to control when a company IPO or an M & A transaction occurs.

**10. There is typically a difference in the information disclosure rights available to the employee buyout group compared to the non-employee investor.** As the owners of the subject company, the employee buyout group is typically entitled to receive all financial and operational information regarding the subject company. Such information often includes (1) historical and current subject company financial statements, (2) a current company, industry, and strategic analysis, and (3) projections of future results of operations (typically). Therefore, the employee buyout group receives a fair amount of subject company financial and operational information. Most closely held companies are not very forthcoming with such company-specific information.

In contrast, unless they have received specific contractual rights, the non-employee parties do not have access to the same subject company financial or operational information. Even special employees (other than a CEO and CFO) may not have as much access to company-specific information as the employee buyout group does. Subject company financing sources may have contractual access to the company financial statements, but they may not have access to other subject company information.

**11. The employee buyout group shareholders and the non-employee shareholders may enjoy different levels of shareholder protection.** The employee buyout group (collectively) and the group members (individually) are protected by state (and, where applicable, federal) securities laws. This is because the relationship between the subject company and the employee buyout group is a securities issuer/stockholder relationship. In contrast, the non-employee party is typically protected by state contract law. This is because the relationship between the company and the non-employee party is between two parties to a contractual agreement.

**12. The most significant difference between the employee buyout group and the non-employee stockholders may be the level of value issue.** As described above, level of value relates to the following two investment criteria:

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

The subject company stock owned by the employee buyout group may represent a different level of value than the company stock owned by the non-employee party. In fact, this scenario is almost certain to occur. That is because two different shareholders cannot both own a controlling interest in the company. If the employee buyout group owns a controlling interest, then the non-employee party does not. And, if the non-employee party owns a controlling interest, then the employee buyout group does not.

In addition, typically, the employee buyout group will have the contractual right that allows the buyout group to acquire ownership control over a period of time. For example, the contract may allow the buyout group to continue to buy blocks of target company stock each year until (1) it owns control of the company or (2) owns 100 percent of the company. In such a case, the buyout group is often treated as a control owner (and the target company stock purchase/sale transaction is often treated as a control level transaction) for stock valuation purposes.

Also, as described, there are numerous factors (contractual and otherwise) that may affect the marketability of the employee-owned company stock compared to the non-employee owned company stock. The valuation analyst will consider all of these factors in assessing where each block of company stock falls on the marketability continuum.

## Summary

This second installment in this series discussed the impact of specific security features on the value of the employer company stock. The third and final installment in this series will discuss the impact of the transaction structure on the employee buyout of the subject company. ◆

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