

VALUATION observations



The “Seven Deadly Sins” of ESOP Valuations

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Companies that sponsor employee stock ownership plans (“ESOPs”) are required by ERISA to obtain an independent valuation of the stock held by the ESOP at least annually for purposes of administering the plan. The ESOP trustee is ultimately responsible for procuring, reviewing, and ultimately accepting this valuation. During a testimony in September 2008, the Employee Benefits Security Administration’s (“EBSA’s”) Director of Enforcement emphasized the importance of ESOP valuations: “The fiduciary must make prudent investment selections, and has an on-going obligation to monitor the plan’s investments... it would be difficult, if not impossible, for a fiduciary to fulfill these fiduciary responsibilities if the fiduciary lacked correct information concerning the value of a plan’s assets.” Therefore, accepting a bad valuation at face value may constitute a fiduciary breach by the ESOP trustee. Despite the importance of ESOP valuations and the scrutiny that valuations may receive, we continue to see critical mistakes in ESOP valuations. These mistakes, the “seven deadly sins” of ESOP valuations, are outlined below.

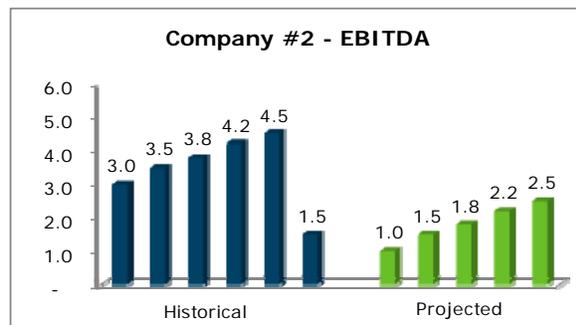
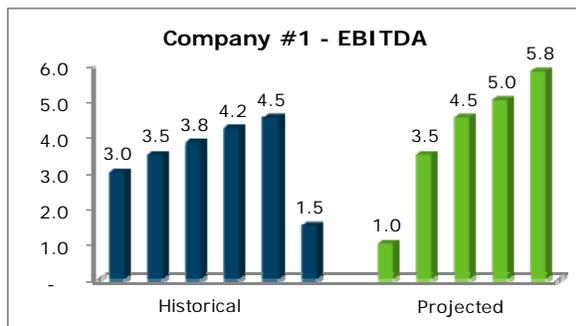
#1: Backward-Looking Rather than Forward-Looking Valuations

The value of any investment is inherently forward-looking, since value is often best described as the present value of all future cash flows associated with an investment. Many valuation approaches are forward-looking in nature: the market approach utilizes pricing multiples based on the market’s assessment of future performance, while the income approach uses a discount rate to capitalize anticipated performance. Nevertheless, we often see valuation models that are based on historical performance, such as capitalizing a company’s five-year average historical earnings, without discussion of whether historical performance is expected to serve as a proxy for future performance. To see the peril in such an approach, take a look at the following charts. These two companies performed identically historically, and as such they would receive the same value under a valuation method that only considered historical performance. However, management’s projections indicate these companies are forecasted to perform in a starkly different manner during the next five years.

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If these companies had the same value (or price), which would you rather own?



Reliance on historical performance without careful analysis of expected future performance can drastically understate or overstate the value of ESOP shares.

#2: Failure to Maintain a Long-Term Perspective on Value

Since shares held in participants’ ESOP accounts are primary a retirement benefit, the investment horizon is generally long for most participants. As such, shares should be valued with a long-term perspective. By over-emphasizing a

company’s performance in a single year, valuers could perpetuate unnecessary and inappropriate share price volatility, which could be disruptive and confusing to participants and fiduciaries and may even be downright unfair to participants (especially those exiting or entering the plan).

#3: Inappropriate “Normalization” Adjustments

It is often appropriate for a valuation professional to “normalize” (i.e., adjust) a company’s reported earnings to remove the impact of various unusual, non-operating, or non-recurring items so as to better reflect the ongoing operating performance of the company. It is extremely important to remember that the resulting cash flows should be reflective of the “normalized” cash flows available to the ESOP shareholders.

A few of the most common inappropriate adjustments we see involve executive compensation (usually prior to the ESOP formation) and ESOP contributions (usually in the years following the ESOP formation). For example, if the valuator makes a downward adjustment to executive compensation in the valuation for the ESOP formation, this results in a higher transaction price. While it may be appropriate to adjust for executive compensation to reflect anticipated post-transaction compensation levels, it is not appropriate to make this adjustment if

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compensation is not expected to change immediately after the transaction. As a second example, it is common for valuation professionals to eliminate ESOP contribution expenses for various reasons (e.g., since this is a financing-related expense, and since it may reflect an extraordinarily large retirement benefit). However, it may be inappropriate to eliminate ESOP contribution expenses without also factoring in a normalized retirement benefit expense. This is especially true if the ESOP contribution replaced another employer retirement benefit, such as a contribution to a 401(k) plan. By disregarding the reality that companies typically must pay a retirement benefit to attract and retain employees, valuers may understate expenses and therefore overvalue the subject company.

#4: Reliance on a Single Valuation Approach

Valuations that utilize multiple valuation approaches are generally better supported than those that rely on a single method. For successful operating companies, the most common valuation approaches include the discounted cash flow method, the guideline public company method, and the guideline transaction method. Nearly every company valuation could include a discounted cash flow method, as the primary required input is a (formal or informal) forecast from management. The guideline public company method is also common since there are publicly traded companies in many industries. Lastly, there are a number of large and rapidly

growing databases that capture transaction pricing of privately-held companies, which is the primary source of information for the guideline transaction method.

Each valuation method has certain advantages and disadvantages. For example, the guideline public company and transaction methods utilize market data, providing strong indicators of market pricing for the industry. At the same time, the discounted cash flow method incorporates company-specific growth plans, risks, conditions, etc. By relying on multiple methods, the valuator captures the strengths of each method while reducing the impact of biases that may exist within any one method. With so much available data, the valuator should make every attempt to employ multiple valuation methods whenever possible.

#5: Failure to Account for Repurchase Obligation

ESOP participants have the benefit of a “put option” for their ESOP shares, by which the sponsoring company is obligated to purchase those shares at their fair market value at the time of a triggering event (e.g., death, retirement, termination of employment, exercising of diversification rights, etc.). As a result, the sponsoring company has a corresponding liability related to this repurchase, and this is often a major financial obligation for many mature ESOP

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companies. Valuators have many ways of addressing this repurchase obligation, and there is no consensus among valuers as to the most appropriate approach to properly reflect this liability. Nevertheless, every ESOP valuation should analyze and discuss this obligation and make some effort to quantify the impact of this obligation on the concluded stock value.

- The “Seven Deadly Sins” of ESOP Valuation*
- 1. Backward-Looking Valuations*
 - 2. Failure to Maintain Long-Term Perspective*
 - 3. Inappropriate “Normalization” Adjustments*
 - 4. Reliance on a Single Valuation Approach*
 - 5. Failure to Account for Repurchase Obligation*
 - 6. Inappropriate Documentation*
 - 7. Selecting the Wrong Valuation Practice*

#6: Inadequate Documentation

Clearly, the most common shortcoming of ESOP valuations is the lack of proper documentation. The quality of the valuation opinion may be rendered meaningless if that opinion is not adequately documented in a written report. An ESOP valuation report should be a comprehensive document that discusses all aspects of the valuation, including the company, its industry, its historical and projected financial performance, the valuation approaches utilized, the key assumptions within those approaches, and any other factors that are integral to the valuation conclusion. All major calculations should be displayed so their accuracy can be verified, whether in the body of the report or through the inclusion of supporting exhibits. This

documentation is critical for providing: (a) support and documentation to the ESOP trustee to make informed investment decisions and appropriate administration of the shares in the plan, and (b) objective support to withstand potential regulatory scrutiny (i.e., ERISA and IRS) in the case of an audit or challenge. While there is no “required” length for a valuation report, the vast majority of comprehensive valuation reports might be 50 to 100 pages.

#7: Selecting the Wrong Valuation Practice

Business valuation is a specialized industry, and ESOP valuation is a sub-niche within that specialty. While finding a firm with extensive valuation experience can be challenging - and finding one with ESOP expertise is often even more difficult – selecting a high quality and experienced valuation firm is perhaps the most critical decision that an ESOP trustee makes. Care should be taken to ensure that the selected firm has extensive valuation and ESOP experience, and references of ESOP clients and advisors should be checked.

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Also, the firm should be involved with the ESOP Association and other appropriate professional organizations. Lastly, it is often possible to determine whether professionals are “thought-leaders” in the industry by reviewing whether they speak or publish articles on valuation and ESOP-related topics. While it may not be necessary to hire nationally-recognized valuation firms if they charge an excessive price, it is important to understand that there are fees associated with high quality valuation work, and decisions based solely on cost are usually poor decisions.

Summary

Valuation plays a critical role in the successful implementation, administration, and termination of an ESOP. Further, in many ESOP-owned companies, ESOP shares may represent a large portion of the retirement account of company employees. Care should be taken to ensure that ESOP valuations are performed by a highly qualified firm and that the valuation analysis and report do not contain any of the above-referenced “seven deadly sins” of ESOP valuation. 

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