The ESOP Association

# From A to Z: Understanding the Annual ESOP Valuation Timeline & Administrative Process

Midwest Regional Conference|

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# Why is an Annual Valuation Needed?

- Required by ERISA & Plan Document
- Since no open market exists, value is determined by independent appraiser
- Department of Labor requires shares are valued at least annually, using the Internal Revenue Service's (IRS) standard value of Fair Market Value (FMV)

# Parties Involved in Annual Process

- Company management
- Trustee
  - External or internal
- Valuation firm
- Plan administrator
- Legal

# ERISA Fiduciary Standards and Duties

- ERISA fiduciaries must act:
  - Solely in the interest of plan participants and beneficiaries
  - For the exclusive purpose of providing benefits to participants and beneficiaries
  - With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matter would use in the conduct of an enterprise of like character and with like aims
  - In conformance with the Plan and Trust documents, as long as the documents are consistent with ERISA
- ERISA Fiduciary duties:
  - Loyalty
  - Prudence
  - Diversification (ESOP exception)

# Who Must Initiate and Complete the Valuation Process?

- The Trustee is always a fiduciary and is responsible for determining stock value
- Trustee engages the qualified independent valuation advisor
- Fiduciary standards are the same for experienced or non-experienced Trustees
- Trustee who blindly relies on valuation expert is not protected under prudence standard
- Reliance on appraiser is justified when the fiduciary:
  - Reads the report and supporting documents
  - Understands the report
  - Identifies, questions, and tests the underlying assumptions
  - Verifies that the conclusions are consistent with the data and analyses
  - Verifies that the appraisal is internally consistent and makes sense

# Trustee's Process for Selecting Valuation Firm

- Trustee selects and engages the ESOP valuation advisor
  - ESOP valuation advisor must be independent
  - Has the valuation advisor performed work (related to the specific engagement) for any party other than the ESOP or trustee? If so, how long ago? How much time should pass before its ok to engage?
- Trustee must investigate qualifications of ESOP valuation advisor (document process)
  - Depth of staffing
  - Credentials/certifications
  - ESOP experience/ESOP community involvement
  - Industry knowledge/experience
  - Criminal/civil litigation
  - Insurance coverage and liability limitations
  - Professional affiliations (NCEO, TEA)
  - References

# Trustee's Process for Selecting Valuation Firm (cont'd)

- Engagement process
  - Explain start to finish (timeline)
  - Read and understand the agreement every year
  - Provide appropriate comments
  - Verify who is the client in the agreement
  - Verify what the valuation covers
  - Verify appropriate signers are signing
- Appraiser must report solely to the Trustee
  - Duty to insure that complete and accurate information is provided to trustee

# Annual Process Step 1: Timeline

- Establish expectations and milestones for process
- Call is preferred but email at the very least
- Typical people involved include management, Trustee, valuation firm, auditor, and TPA
- Layout calendar of events and parties accountable
  - e.g., company visit, internals/audit, budget, valuation report, statements to participants

# Annual Process Step 2: Due Diligence List

- Request for financial, operational, corporate, legal, and ESOP items
- Long list, certain items may not be available/applicable
- Useful to have call to discuss and eliminate any wheel spin
- Over time, document gathering becomes quicker

# Annual Process Step 3: Company Visit

- Meeting between management, Trustee, and valuation firm
- Best practice to schedule at least a week after receiving due diligence information
- In-person meeting is preferred
  - An in-person meeting gives an opportunity for the Trustee and valuation advisor to take a tour of the facilities and the company operations
- Meeting duration varies (e.g., 2 hours, all-day, multiple days)

# Annual Process Step 3: Company Visit

- Purpose is to get the “story” of the year
- Typical topics include:
  - Operations
  - Customers
  - Vendors
  - Industry
  - Competition
  - Employees & Management
  - Facilities & Equipment
  - Financial
  - Budget
  - Legal

# Annual Process Step 4: Financial and Valuation Analysis

- Incorporate financial data into model
  - Audits and internals
  - Forecast
  - Other
- Financial data is reviewed carefully with analysis of current year performance, ratios, actual vs. budget, forecast assumptions, changes in forecast
- Economic, industry, and market research
  - Growth rates, profit margins, trends, regulatory, risks, etc.
- Send draft financial schedules and follow up questions to management

# Valuation Theory

- Value is determined by an assessment of the relationship between the future returns generated on an investment and the risk of attaining those returns

- The art of business valuation is to:
  - Understand the potential returns to shareholders
  - Assess the risk of attaining those returns
  - Convert the concept into a value using various financial models and tools

THEORY

ART

# Value Drivers

- Risk
  - Higher risk ⇨ Lower value, and vice versa
- Influencing Factors:

| External Factors | Internal Factors |
|---|---|
| Economic Condition | Key Person / Bench Strength |
| Industry Condition | Financial Performance / Outlook |
| Regulatory Environment | Products / Services |
| Competitive Landscape | Customer Concentration |
| | Supplier Concentration |

# Standard of Value

- Guidance & Regulatory Agencies
  - Internal Revenue Service (Revenue Ruling 59-60)
  - Department of Labor (DOL)
    - Title I of the Employee Retirement Income Security Act (“ERISA”) and the Proposed Regulation Relating to the Definition of Adequate Consideration (Prop. Reg. Section 2510.3-18 (b)(2)(i))
- Fair market value:
  - “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 any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for the asset.”

# Commonly Used Appraisal Methodologies

## Comparable Public Company Analysis

### Market Approach

- Comparable Public Company Valuation technique estimates the value of a company by comparing it to similar public companies

## Comparable M&A Transaction Analysis

### Market Approach

- The primary focus of the Comparable Transactions method is to examine prices found in relevant transactions

## Discounted Cash Flow Analysis (“DCF”)

### Income Approach

- The Discounted Cash Flow valuation technique values a company based on the present value of future cash flows plus a terminal value

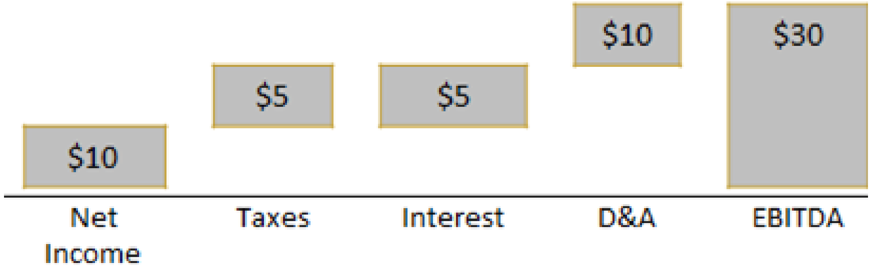
## Tangible Asset Method

### Asset Approach

- The primary focus of the Tangible Asset Method is to determine a market value of the assets less a company’s liabilities (limited application)

# Annual Process Step 4: Financial and Valuation Analysis

- EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization
  - EBITDA = Net Income + Taxes + Interest Expense + Depreciation/Amortization
  - EBITDA is value to the Enterprise
  - Net income is value to shareholders
  - Interest is value to debt holders




- For valuation purposes, should exclude one-time, non-recurring items

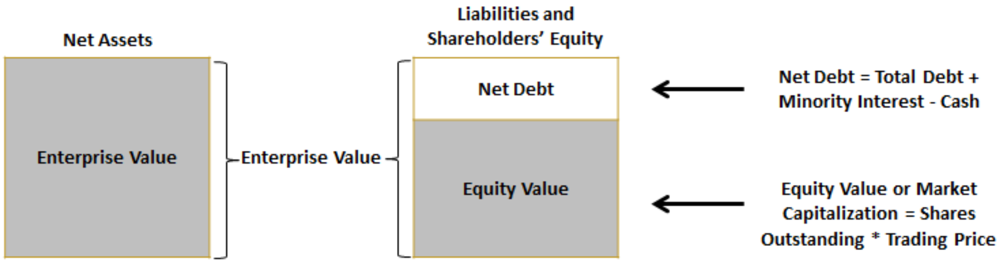
# Annual Process Step 4: Financial and Valuation Analysis

- Profitability
  - Goal is to increase profit
  - Increasing sales and cutting expenses increases profit
- Cash Flow
  - Value is a function of future cash flow and risk
  - Takes into account capital expenditures, working capital changes, etc.
  - Goal is to increase future cash flow
  - Higher future cash flow ⇨Higher value

# Annual Process Step 4: Financial and Valuation Analysis

- Enterprise Value
  - Enterprise Value = Market Value of Operating Assets
  - Equity Value = Market Value of Shareholders' Equity

**Equity Value = Enterprise Value + Cash - Debt**



# Annual Process Step 4: Financial and Valuation Analysis

- Appraisal firm's value review occurs after reviewing all due diligence information, meetings/calls/emails with management, research and analysis
  - Typically includes senior reviewer, project manager and analyst
- Once financial and valuation analysis is complete, valuation report is compiled

# Annual Process Step 5: Valuation Report

- Draft report is prepared for the Trustee
- Detailed narrative of client's history, operations, industry and economic condition, financial analysis, and valuation analysis
- Report goes through a review process before draft is issued to Trustee

# Annual Process Step 5: Valuation Report

- Valuation Report Content Requirements:
  - Scope of assignment
  - Description of security
  - Nature and history of business
  - Economic/industry conditions and outlook
  - Historical and forecast financial analysis
  - Company's earnings capacity
  - Company's dividend paying capacity
  - Whether company has goodwill or other intangible value
  - Appraisal methodologies
  - Summary of qualifications of valuation advisor
  - Significant factors relied upon

# Annual Process Step 6: Trustee Review and Committee Meeting

- The valuation advisor will provide the Trustee with a draft valuation report
- The Trustee will distribute the draft report to the Trustee committee for their review
- The Trustee will schedule a meeting with the valuation advisor and the Trustee committee after they have had a reasonable amount of time to review the draft report

# Review of Draft Valuation Report

- Key elements of the draft report the Trustee will review:
  - Drivers of value
  - Quality/reasonableness of projections
  - Operations
  - Strategic initiatives
  - Customer/supplier concentration
  - Financial outlook
  - History of company
  - Offers to buy/sell
  - Management/board composition and changes
  - Litigation
  - Advisor relationships (bank, CPA, insurance)
  - Executive compensation
  - Repurchase obligation and funding strategy

# Approval of Value and Issuance of Final Report

- Trustee must review and understand the report
- Trustee should question assumptions
- Valuation advisor should explain analysis and changes from prior year
- Trustee must educate itself as necessary to understand the report
- ALWAYS DOCUMENT THE PROCESS
- The Trustee is establishing value for the creation of benefits

# Approval of Value and Issuance of Final Report

- The draft report will be updated after the committee meeting with any comments or revisions discussed during the meeting
- The Trustee will request the final report from the valuation advisor
- The final report and the final per share price will be distributed to the Company

# Annual Process Step 7: Recordkeeping and Third-Party Administration

- The TPA will need the stock price from the final report to complete the following:
  - Share allocations
    - e.g., inside loan, recycling, forfeitures
  - Compliance testing
    - e.g., 404a, 415, 410b, and 409p
  - Participant statements
    - Once the participant statements have been generated, the TPA will also prepare the distribution paperwork for those eligible
  - Form 5500

# Annual Process Step 8: Other

- The valuation report is only for ESOP administrative purposes; however, the report will be requested by the following:
  - Auditor
    - Both the financial statement auditor and ESOP plan auditor will request the valuation report
  - Bank
  - Insurance Company

# Timing of Milestones in the Process

- Engagement
  - soon after the valuation date
- Due diligence collection
  - 2 to 4 weeks
- Company visit
  - 1 to 2 weeks after due diligence provided
- Financial and valuation analysis
  - 2 to 6 weeks
- Preparation of the draft report by valuation firm
  - 1 week
- Approval of the draft report
  - 1 week
- Preparation of the TPA Reports
  - 6 weeks after the final stock price is known

# ADMIN

- Please fill out a session evaluation on the mobile app
- Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs
- Remember to get your CPE sheet stamped before and after each session for CPE credit

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