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ABCs of Stock Valuation for Employee-Owners

Radd L. Riebe, JD, ASA

Managing Director

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What is an ESOP?

- It is a **Qualified Defined Contribution Retirement Plan**
 - Similar benefits of other retirement plans
 - Tax deductible contributions for employer
 - Tax deferred growth of investments for employees
 - Invests primarily in Employer's Securities
 - Only plan that allows leveraging
 - There are currently 11,500 ESOPs that cover an estimated 10 million employees

How is an ESOP structured?

- The assets are held in trust for the benefit of plan participants and their beneficiaries
- Trust is tax exempt
- Assets invested primarily in Company Stock
 - Highest class of stock
 - Voting
- Contributions are made to the Trust in the form of cash stock or a combination of cash and stock

Nonleveraged ESOP Structure

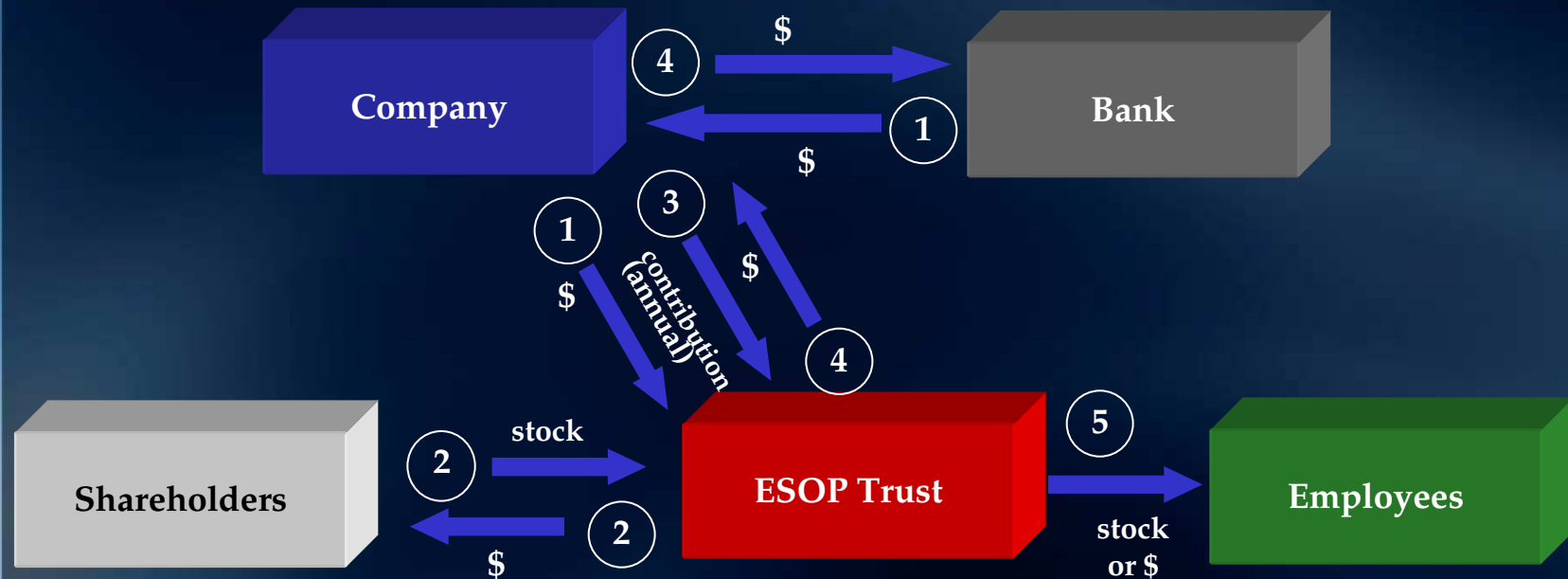


Each year, company contributes (1) stock or (2) cash to the ESOP to buy stock. Employees pay nothing. The ESOP holds stock for employees and periodically notifies them of how much they own and how much it is worth. (3) Employees receive stock or cash when they retire or otherwise leave the company according to vesting schedule.

Leveraged ESOP Structure

- An ESOP is considered to be leveraged when it or its corporate sponsor borrows money from a bank or other qualified lender.
- Usually the company will guarantee the loan.
- As the loan is repaid, the stock held as collateral on the loan is released to individual employee accounts.

Leveraged ESOP Structure (Cont.)



(1) Bank lends money to company, which in turn lends to ESOP Trust (2) ESOP Trust buys stock from existing shareholders. (3) Company makes annual tax deductible contributions to ESOP Trust. (4) ESOP Trust repays company, which in turn repays bank (5) Employees collect stock or cash when they retire or leave the company.

General Tax Advantages of ESOPs

- Deductible purchase of stock, or deductible payments of loan principal
 - Reduce cost of acquiring stock
 - Reduce Company's taxable income
- Shareholder ability to elect to defer tax on capital gain realized upon sale to ESOP ("1042 rollover")
 - Defer tax to later date, or completely eliminate tax (approximately 20% state and federal)
- Employee benefit and incentive by acquiring interest in employer stock with no out-of-pocket cost
- Deferral of taxation by employees until actually taken into income
- S Corporation owned by ESOP will reduce or completely eliminate federal income tax on business profits

Regulations or Requirements

- Discrimination Tests
- Annual Contribution Limits
- Diversification – 55 years old and 10 years with company. Allowed to diversify 25% - 50% of their account balance.
- Put Rights: Retirement, Death or Disability – 1 year; Other reason – 5 years
- **ESOP can not pay more than Fair Market Value**

- **Trustee**
- **Financial Advisor**
- **Legal Advisor**

When Do You Value ESOP Stock

- **Annually** as of each ESOP Plan year end (which may be different than the company's accounting year end).
- As of a specific date **whenever the ESOP buys stock from or sells stock to a party in interest**, e.g. the company and certain shareholders.

ESOP Valuation Issues

- **Who May Value ESOP Stock**—An ESOP fiduciary who typically hires an **independent appraiser** who serves as a financial advisor to the fiduciary. The ESOP fiduciary evaluates and accepts the valuation to determine the stock value.
- It is highly recommended this ESOP appraiser/financial advisor is active in the ESOP community and regularly performs ESOP valuations.
- The IRS and DOL may challenge the valuation of ESOP stock and penalties may result from improper transactions. Therefore, the value of stock bought by a closely-held ESOP company must be credible and comply with all relevant laws and regulations.

Valuation Definitions

- Adequate Consideration: fair market value as determined in good faith by the ESOP trustee (**DOL standard of value**)
- Fair Market Value: a value, expressed in cash or its equivalent, at which a willing seller and a willing buyer, both being informed of the relevant facts about the business, could reasonably conduct a transaction, neither person acting under compulsion to do so (**IRS standard of value**)
- Strategic Value v. Fair Market Value: accounting for premium for control and discount for lack of marketability

The Issue of “Fairness”

- Absolute Fairness:
 - The ESOP may not pay more than fair market value for its stock.
- Relative Fairness:
 - The ESOP must receive terms that are fair in relation to the terms given to other investors
 - Must consider what the ESOP is contributing and what it is receiving, relative to others
 - Should address the risk as well as the return on the ESOP’s investment

Additional “Fairness Issues”

- Is the dividend on the ESOP’s stock in excess of a reasonable rate?
- Are the terms and the interest rate of the ESOP loan reasonable?
- Solvency opinion to guard against fraudulent conveyance?

- Immediately prior to the Transaction:
 - Ignore impact of ESOP debt
 - Ignore future ESOP contributions
 - Investment decision from financing decision

Post Transaction Drop in Value

- Leveraged ESOPs experience dilution related to the debt used to finance the deal
- Dilution is offset partially by debt tax shield
 - Principal payments are tax deductible if used to repay ESOP debt
- Future appreciation is based on:
 - Increases in revenue and profitability
 - Changing market conditions (i.e., pricing multiples/interest rates)
 - Debt repayment

Current Thinking Related to DLOM and Control Premiums

- DLOM
 - DOL believes that some discount for lack of marketability is appropriate – consideration of repurchase obligation is more closely scrutinized
- Control Premiums
 - Control premiums are lower than premiums in the public market due to strategic benefits
 - ESOP can only pay a premium for control when it is acquiring control (i.e., no control premium paid when ESOP goes from 60% owner to 100% owner)

Valuation Due Diligence Procedures

- Research historical and prospective company data
- Conduct management interviews and due diligence
- Analyze and adjust financial awareness (as appropriate)
- Collect and review economic and industry data
- Choose and analyze guideline public companies and transactions
- Comparative financial and risk analysis
- Determine appropriate multiples capitalization rates, etc.

- Repurchase obligation
- Post-transaction ESOP debt
- Equity compensation plans
- Value of “S” Corporation tax status

Recent Trends in ESOP Transactions

- Using different classes of stock to complete transactions
 - Convertible Preferred Stock
- Management Incentives are increasingly used in ESOP deals
 - Phantom Stock, SARs and Stock Options
- Different lending sources are increasingly used to complete transactions
- 100 percent S Corp. ESOPs