Valuation and Financial Fairness Considerations in ESOP Transactions

Rutgers School of Management and Labor Relations 2nd Annual ESOP and Equity Compensation Conference

October 26, 2018
Disclaimer

Information contained herein is of a general nature and is provided for informational purposes only. Laws governing ESOP transactions and the rules under section 1042 of the Internal Revenue Code of 1986, as amended, are complex, and persons considering an ESOP or section 1042 transaction should seek professional guidance from their tax and legal advisors.
Why is Valuation Necessary?

• The majority of companies with ESOP ownership are privately-held with no active market for the stock

• When the ESOP Trustee is the buyer or seller of stock, the Trustee must have assurance that it is paying no more than or receiving no less than fair market value

• When the ESOP Trustee is the owner of the stock, the Trustee is required to determine the fair market value on at least an annual basis
  • Annual reporting requirements
  • To satisfy ESOP participant repurchase obligations
Independence of the Advisor

• Proposed Department of Labor Regulations of 1988 and subsequent guidance require the following of an ESOP Trustee financial advisor:

- Independent of all parties
- Hired by and report to the ESOP Trustee
- Represent financial interests of the ESOP

• The valuation and fairness opinion performed by the ESOP Trustee financial advisor is for the exclusive use of the ESOP Trustee. No other party (with the exception of counsel in limited instances) may rely on it, and the dissemination of the valuation is controlled by the ESOP Trustee and is largely restricted.
The Valuation Process

- Define Purpose of Valuation
  - Feasibility Analysis
  - ESOP Transaction / Fairness Opinion
  - Annual Update Valuation
  - Subsequent Stock Transactions
Valuation Issues in a Transaction

• **Absolute Fairness**
  
  • The ESOP may not pay more than fair market value for its stock (but can pay up to fair market value).

• **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 paying and what it is receiving, relative to others.
  
  • Should address the risk as well as the return on the ESOP’s investment.
Valuation Definitions

• Adequate Consideration
  • Fair market value as determined in good faith by the ESOP trustee

• 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, both parties being able, as well as willing, to trade and being well-informed about the asset and the market for the asset.
Valuation Definitions

• Enterprise Value vs. Equity Value
  • Enterprise Value: The value of the company’s total invested capital (i.e., debt + common and preferred equity)
  • Enterprise Value – Debt = Equity Value
• Levels of Value
  • Control vs. Minority
  • Level of Marketability

Valuation Definitions

- **Control Value – Strategic Buyer**
  - **Premium for Strategic Synergies**

- **Control Value – Financial Buyer**
  - **Premium for Control**
  - **Discount for Lack of Marketability**

- **Marketable Minority Value**
  (Wall Street Journal Price)

- **Privately-held Minority Value**
Valuation Definitions

• For ESOP valuation purposes, we assume the subject company is a C Corporation and will tax effect S Corporation pre-tax income.

• However, an S Corporation that is 100% owned by an ESOP is exempt from Federal income taxes, which significantly enhances cash flow for debt service post-transaction.
The Valuation Process

• **Information / Intelligence Gathering**
  - Documents / information request
  - Site visit
  - Corporate due diligence and management interviews
  - Research relevant market, economic, and industry segments

• **Analysis of Information**
  - Financial statements – possible adjustments
  - Investment market and guideline company data
  - Projected financial information
The Valuation Process

• Develop Indications of Value
  • The Market Approach
  • The Income Approach
  • The Asset-Based Approach

• Develop Valuation Conclusion
  • Consideration of appropriate discounts and/or premiums
  • Relevance of each valuation approach
The Market Approach

• Guideline Publicly Traded Company Method
  • Looks at publicly traded comparable companies for valuation guidance

• Guideline Transaction Method
  • Looks at change of control transactions of comparable companies (publicly traded and closely held)
# The Market Approach – Selection of Guideline Companies

## Business Characteristics
- Markets served
- Product or service and process
- Competitive positioning
- Cyclicality and seasonality
- Size and diversification

## Financial Characteristics
- Profit margins
- Growth
- Capital intensity

## Market Factors
- Sale transaction
- Publicly-traded value
- Market conditions at time of the transaction

## Reliability of Data
- Public comps or public filings
- Private transactions, proprietary databases, self-reported
- Transaction structure
- Adjustments made to data
Guideline Publicly Traded Company Method

Guideline Public Company Data
as of December 31, 2015

In Millions of U.S. Dollars

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Sales</th>
<th>Growth</th>
<th>EBITDA</th>
<th>Growth</th>
<th>EBITDA Margin</th>
<th>Enterprise Value</th>
<th>Sales</th>
<th>EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treehouse Foods, Inc.</td>
<td>$2,946</td>
<td>-8.12%</td>
<td>$378</td>
<td>1.86%</td>
<td>11.79%</td>
<td>$4,674</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ingenico Group</td>
<td>1,607</td>
<td>-26.85%</td>
<td>474</td>
<td>34.33%</td>
<td>21.58%</td>
<td>7,510</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fresh Del Monte Produce Inc.</td>
<td>3,928</td>
<td>-2.01%</td>
<td>258</td>
<td>-2.27%</td>
<td>5.71%</td>
<td>2,244</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flowers Foods, Inc.</td>
<td>3,697</td>
<td>-2.65%</td>
<td>444</td>
<td>4.22%</td>
<td>11.55%</td>
<td>5,448</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CH Robinson Worldwide Inc.</td>
<td>13,470</td>
<td>-0.04%</td>
<td>915</td>
<td>14.89%</td>
<td>6.79%</td>
<td>9,802</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The Hain Celestial Group, Inc.</td>
<td>2,469</td>
<td>-11.85%</td>
<td>358</td>
<td>19.14%</td>
<td>11.70%</td>
<td>4,899</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>$3,321</td>
<td>-5.4%</td>
<td>$411</td>
<td>9.6%</td>
<td>11.6%</td>
<td>$5,174</td>
<td></td>
<td></td>
</tr>
<tr>
<td>XYZ Company, Inc. (LTM)</td>
<td>$10</td>
<td>51.20%</td>
<td>$2.2</td>
<td>199.50%</td>
<td>22.00%</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Examine valuation multiples
- Apply valuation multiples to subject company based on relative risk/return profile
- Factors impacting the selected multiples include:
  - Size, EBITDA growth, EBITDA margin, etc.
Selecting the Multiple

PROFITABILITY VS. SALES MULTIPLE

EBITDA MARGIN

SALES MULTIPLE

PROFITABILITY VS. SALES MULTIPLE

EBITDA MARGIN

SALES MULTIPLE
### Example

<table>
<thead>
<tr>
<th>Financial Fundamental</th>
<th>Subject Company</th>
<th>Selected Multiple</th>
<th>Indicated Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>$1,500</td>
<td>8.0 - 9.0</td>
<td>$12,000 - $13,500</td>
</tr>
<tr>
<td>EBITDA</td>
<td>2,200</td>
<td>6.0 - 6.5</td>
<td>13,200 - 14,300</td>
</tr>
<tr>
<td>Revenues</td>
<td>10,000</td>
<td>1.10 - 1.20</td>
<td>11,000 - 12,000</td>
</tr>
<tr>
<td>Book Value</td>
<td>5,500</td>
<td>1.80 - 2.00</td>
<td>9,900 - 11,000</td>
</tr>
</tbody>
</table>

**Indicated Enterprise Value**  
$11,500 - $12,700
Guideline Transaction Method

• Source of information is public documents, databases, intermediaries, investment bankers
• Transactions represent sale of 100% interest in company. Analyst attempts to identify major terms
  • Eg: seller financing, contingent payments
• May represent strategic price
• Value often expressed as multiples of EBITDA
• Timeliness of data may be an issue
• Often a reasonable sanity check
## Guideline Transactions

*In Millions of U.S. Dollars*

<table>
<thead>
<tr>
<th>Date</th>
<th>Target Company</th>
<th>Enterprise Value</th>
<th>LTM Revenue</th>
<th>LTM EBITDA</th>
<th>LTM EBITDA Margin</th>
<th>EV/LTM Sales</th>
<th>EV/LTM EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/27/2016</td>
<td>Krispy Kreme Doughnuts, Inc.</td>
<td>$1,320</td>
<td>$523</td>
<td>$73</td>
<td>13.96%</td>
<td>2.52x</td>
<td>18.08x</td>
</tr>
<tr>
<td>4/29/2016</td>
<td>EVINE Live Inc.</td>
<td>152</td>
<td>678</td>
<td>12</td>
<td>0.94%</td>
<td>0.22x</td>
<td>12.81x</td>
</tr>
<tr>
<td>5/1/2013</td>
<td>Charter Communications, Inc.</td>
<td>22,581</td>
<td>7,504</td>
<td>2,644</td>
<td>35.05%</td>
<td>3.01x</td>
<td>8.54x</td>
</tr>
<tr>
<td>12/31/2012</td>
<td>Live Nation Entertainment, Inc.</td>
<td>2,622</td>
<td>5,819</td>
<td>424</td>
<td>7.17%</td>
<td>0.45x</td>
<td>6.18x</td>
</tr>
<tr>
<td>12/11/2012</td>
<td>TripAdvisor Inc.</td>
<td>8,783</td>
<td>731</td>
<td>308</td>
<td>40.92%</td>
<td>12.01x</td>
<td>28.53x</td>
</tr>
<tr>
<td>9/26/2012</td>
<td>J. Alexander's Holdings, Inc.</td>
<td>100</td>
<td>161</td>
<td>11</td>
<td>6.93%</td>
<td>0.62x</td>
<td>8.99x</td>
</tr>
<tr>
<td>2/27/2012</td>
<td>Nautilus Inc.</td>
<td>52</td>
<td>180</td>
<td>7</td>
<td>4.11%</td>
<td>0.29x</td>
<td>6.99x</td>
</tr>
<tr>
<td>12/22/2011</td>
<td>Lakeland Industries Inc.</td>
<td>60</td>
<td>103</td>
<td>6</td>
<td>6.59%</td>
<td>0.58x</td>
<td>10.58x</td>
</tr>
<tr>
<td>8/30/2011</td>
<td>Lions Gate Entertainment Corp.</td>
<td>1,611</td>
<td>1,517</td>
<td>103</td>
<td>8.79%</td>
<td>1.06x</td>
<td>15.64x</td>
</tr>
<tr>
<td>6/3/2011</td>
<td>Cracker Barrel Old Country Store, Inc.</td>
<td>1,558</td>
<td>2,434</td>
<td>235</td>
<td>9.66%</td>
<td>0.64x</td>
<td>6.63x</td>
</tr>
<tr>
<td></td>
<td>75th Percentile</td>
<td>2,370</td>
<td>2,205</td>
<td>290</td>
<td>13%</td>
<td>2.16x</td>
<td>14.93x</td>
</tr>
<tr>
<td><strong>Median</strong></td>
<td></td>
<td>$1,439</td>
<td>$705</td>
<td>$88</td>
<td>8%</td>
<td>0.63x</td>
<td>9.79x</td>
</tr>
<tr>
<td></td>
<td>25th Percentile</td>
<td>113</td>
<td>266</td>
<td>11</td>
<td>7%</td>
<td>0.48x</td>
<td>7.38x</td>
</tr>
<tr>
<td>XYZ Company, Inc. (2015)</td>
<td></td>
<td>$10.00</td>
<td>$2.20</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Income Approach

• The value of an investment asset can be estimated as the risk adjusted present value of the expected future economic income associated with the asset.

• Starts with the subject company’s projected “free cash flow”:

  EBIT
  Less: Taxes
  Plus: Depreciation & Amortization
  Less: Capital Expenditures
  Less: Working capital investment
  = Free Cash Flow Available to Invested Capital Holders
Discount Rate

• Represents an “opportunity cost” or required rate of return necessary to induce investors to commit available funds to the subject investment, given its level of risk.

• The weighted average cost of capital (WACC) is an overall discount rate based on individual rates of return for enterprise value (equity and debt).

• These equity and debt required rates of return are then weighted based upon their respective portions of an expected capital structure.
Terminal Value

• Represents value beyond the forecast period

• Perpetual Growth Method
  • Assumes value for the business continues to operate in perpetuity, growing Free Cash Flow at a constant rate

• Exit Multiple Method
  • Assumes value for the business at the end of the projection period by applying multiples of Revenue, EBIT, or EBITDA

• Present value of terminal value added to present value of interim cash flows to derive indicated Enterprise Value

• Range of discount rates and terminal value assumptions are used for transactions
### Equity Discount Rate

<table>
<thead>
<tr>
<th>Description</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk-Free rate of Return [a]</td>
<td>2.68%</td>
</tr>
<tr>
<td>Market Equity Risk Premium [b]</td>
<td>6.03%</td>
</tr>
<tr>
<td>Small Stock Risk Premium [b]</td>
<td>5.60%</td>
</tr>
<tr>
<td>Company-Specific Risk Premium [c]</td>
<td>5.00%</td>
</tr>
</tbody>
</table>

**Concluded Equity Discount Rate** 19.31%

### Cost of Debt

<table>
<thead>
<tr>
<th>Description</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-Term Cost of Debt [d]</td>
<td>4.75%</td>
</tr>
<tr>
<td>Less: Income Tax Factor [e]</td>
<td>40.0%</td>
</tr>
</tbody>
</table>

**Concluded Cost of Debt** 2.85%

### Weighted Average Cost of Capital

<table>
<thead>
<tr>
<th>Return</th>
<th>Weight</th>
<th>Weighted Average Cost of Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>19.3%</td>
<td>x 75.0%</td>
<td>14.48%</td>
</tr>
<tr>
<td>2.9%</td>
<td>x 25.0%</td>
<td>0.71%</td>
</tr>
</tbody>
</table>

**Weighted Average Cost of Capital** 15.00%

--

[a] Based on 20-year U.S. Treasury bond yield as of the Valuation Date.
[c] Based on the Company's size and significant industry and customer concentration.
[d] baa Corporate Bond yield as of Valuation Date.
[e] Represents a blended state and federal tax rate.
## Discounted Cash Flow

**U.S. Dollars in Thousands**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted EBITDA</td>
<td>$2,310</td>
<td>$2,426</td>
<td>$2,547</td>
<td>$2,674</td>
<td>$2,808</td>
<td>$2,948</td>
</tr>
<tr>
<td>Less: Depreciation &amp; Amortization</td>
<td>(250)</td>
<td>(250)</td>
<td>(300)</td>
<td>(400)</td>
<td>(400)</td>
<td>(400)</td>
</tr>
<tr>
<td>Adjusted operating Income</td>
<td>2,060</td>
<td>2,176</td>
<td>2,247</td>
<td>2,274</td>
<td>2,408</td>
<td>2,548</td>
</tr>
<tr>
<td>Less: income Tax Expense</td>
<td>(824)</td>
<td>(870)</td>
<td>(899)</td>
<td>(910)</td>
<td>(963)</td>
<td>(1,019)</td>
</tr>
<tr>
<td>Net Operating Profit After Taxes</td>
<td>1,236</td>
<td>1,305</td>
<td>1,348</td>
<td>1,364</td>
<td>1,445</td>
<td>1,529</td>
</tr>
<tr>
<td>Add: Depreciation &amp; Amortization</td>
<td>250</td>
<td>250</td>
<td>300</td>
<td>400</td>
<td>400</td>
<td>400</td>
</tr>
<tr>
<td>Less: Capital Expenditures</td>
<td>(250)</td>
<td>(250)</td>
<td>(300)</td>
<td>(400)</td>
<td>(400)</td>
<td>(400)</td>
</tr>
<tr>
<td>Less: Additional Net Working Capital</td>
<td>(100)</td>
<td>(100)</td>
<td>(100)</td>
<td>(100)</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>Enterprise Cash Flow</td>
<td>$1,136</td>
<td>$1,205</td>
<td>$1,248</td>
<td>$1,264</td>
<td>$1,345</td>
<td>$1,429</td>
</tr>
</tbody>
</table>

| Present Value Factor @ 15% | 0.933 | 0.811 | 0.705 | 0.613 | 0.533 |
| Terminal Value (5% Long-Term Growth) | 14,289 |
| Present Value of Cash Flows | 1,059 | 977   | 880    | 775    | 717     | 7,619   |

**Indicated Enterprise Value**  $12,000
Income Approach Pros and Cons

**Pros**

- Theoretically, the most sound valuation method
- Less influenced by market volatility
- Forward-looking
- Based on economic cash flow rather than accounting earnings
- Allows future expected operating strategy to be incorporated into the model

**Cons**

- Highly sensitive to a few key assumptions (e.g. projections and discount rate)
- Increased complexity for early stage companies
- Terminal value often represents a significant portion of total value
- WACC has inherent limitations:
  - assumes constant capital structure
  - does not necessarily reflect projection risk
Asset Based Approach

- Valuation a function of examining the net assets of the company
- Assets & liabilities restated to market value – net assets represent 100% of the Company’s equity
- May require use of asset appraisers if certain asset categories are truly material
  - Eg: Real estate, machinery
- Often not a suitable method for operating companies with intellectual property
- More suitable for, say, real estate holding companies
Synthesis and Conclusion of Value

• Potential ESOP Tax Shield
• Premium for Control / Minority Interest Discount
  • Most likely embedded in cash flows
• Discount for Lack of Marketability
  • Typically considered with respect to ESOP’s “put” option
  • Typical range: 5 percent – 10 percent
Synthesis and Conclusion of Value

• Consider relevance and strengths/weaknesses of each approach
• Reflect impact of cash and interest bearing debt
• Consider non-operating assets and contingent/off-balance sheet liabilities
• Consider all options, warrants, and other forms of synthetic equity
• Thoroughly document and support conclusions, which are presented to ESOP Trustee
### Synthesis and Conclusion of Value

**In Thousands of U.S. Dollars**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Enterprise Value</strong></td>
<td></td>
</tr>
<tr>
<td>Income Approach</td>
<td>$12,000</td>
</tr>
<tr>
<td>Market Approach</td>
<td>12,100</td>
</tr>
<tr>
<td><strong>Concluded Enterprise Value (Rounded)</strong></td>
<td>$12,050</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Adjustments to Enterprise Value</strong></td>
<td></td>
</tr>
<tr>
<td>Enterprise Value</td>
<td>$12,050</td>
</tr>
<tr>
<td>Plus: Cash</td>
<td>550</td>
</tr>
<tr>
<td>Less: Deferred Compensation</td>
<td>(300)</td>
</tr>
<tr>
<td>Less: Interest- Bearing Debt</td>
<td>(3,000)</td>
</tr>
<tr>
<td>** Marketable, Controlling Interest Equity Value**</td>
<td>$9,300</td>
</tr>
<tr>
<td>Discount for Lack of Marketability @ 5%</td>
<td>(465)</td>
</tr>
<tr>
<td><strong>Limited-Marketable, Controlling interest Equity Value (Rounded)</strong></td>
<td>$8,800</td>
</tr>
<tr>
<td>Shares Outstanding</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Share Value (Rounded)</strong></td>
<td>$8.80</td>
</tr>
</tbody>
</table>
Other Valuation Drivers

- Strength and depth of management
- Increased Diversification (risk mitigation)
  - Geographic
  - Product
  - Customer
  - Suppliers
- Firm’s market position and market recognition/industry characteristics
- Compliance/Risk Management/Quality Control
- Growth potential and required capital expenditures
Other Valuation Drivers

• Better cash conversion cycles (optimize working capital)
• Risk and volatility of cash flow
• General market conditions
• Current debt level and repayment of debt over time
• Actual vs. projected performance

*Earnings growth and quality of earnings*
Other Financial Fairness Considerations

• If the ESOP purchase is leveraged, the ESOP trustee will commonly request an opinion regarding the specific terms of the ESOP Loan.

  • Is the interest rate on the loan from the sponsor company to the ESOP (the “ESOP Loan”) in excess of a reasonable rate?

  • Are the financial terms of the ESOP Loan at least as favorable to the ESOP as would be the terms of a comparable loan resulting from arm’s-length negotiations between independent parties?
Other Financial Fairness Considerations

• In addition to adequate consideration question, a Fairness Opinion addresses relative fairness considerations as well, such as:
  • Terms and number of warrants
  • Dilution and vesting parameters of management incentive plans
  • Financial terms of the outside financing and/or financial terms of the related-party financing (i.e. seller notes)
  • Terms and economic impact of any earnouts or clawbacks
Questions?
Contact Information

For further information regarding this document please contact one of the following Stout representatives:

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Aziz El-Tahch is a Managing Director in the Valuation Advisory group and Stout’s ESOP & ERISA Advisory practice Co-leader. He has experience in the valuation of companies, business interests, and securities, for numerous purposes, and has extensive experience in the valuation of business ownership interests in Employee Stock Ownership Plans (ESOPs), and has performed analyses related to ESOP security formation and transactions, determination of transaction fairness and adequate consideration, and annual employer security valuation updates.

Mr. El-Tahch has presented at numerous conferences and seminars on the subjects of valuation and transaction advisory services. He has also published articles on the use of ESOPs to facilitate business transitions and the valuation of intangible property in the context of transfer pricing analyses.

In addition to serving as co-lead of Stout’s ESOP & ERISA Advisory practice, Mr. El-Tahch also serves on the board of directors of Dynetics, Inc., a 100% ESOP-owned aerospace and defense company with approximately 1,400 employees. Prior to joining Stout, Mr. El-Tahch was a Senior Investment Analyst at a New York-based alternative assets investment fund with approximately $500 million under management. At the fund, he focused on credit card debt securitizations, collateralized debt obligation (CDO) and collateralized loan obligation (CLO) securities, and second-lien and mezzanine loans to middle-market companies.

Professional Memberships
- CFA Institute
- New York Society of Security Analysts
- ESOP Association, Member of Legal & Regulatory Committee, former officer of the Executive Committee of the New York/New Jersey Chapter
- Rutgers NJ/NY Center for Employee Ownership, Advisory Board Member
- Association for Corporate Growth
- National Association of Corporate Directors (NACD)
- Advisory Committee, Employee-Owned S Corporations of America (ESCA)
- National Center for Employee Ownership (NCEO)

Community Engagement
- All Angels Episcopal Church of New York City, Finance Committee