

## UNIQUE FACTORS RELATED TO THE VALUATION OF ESOP STOCK

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### INTRODUCTION

The purpose of a business valuation assignment often has a material impact on the value conclusions reached. For example, company valuations performed for the purpose of valuing stock held in an employee stock ownership plan (ESOP) include several unique factors.

This article will discuss some of the unique factors related to the valuation of ESOP stock. Specifically, this article will focus on the more recent developments that impact the valuation of ESOP stock.

### ESOP DEBT "TAX SHIELD"

ESOP stock purchase transactions are often leveraged deals. This means that the company stock purchased by the ESOP is financed with debt that the sponsor company is obligated to repay. The impact of this acquisition debt generally reduces the equity value of the company on a post-transaction basis.

However, there is a unique income tax benefit available to the leveraged ESOP that partially offsets the value decrement caused by the ESOP debt. Specifically, principal payments made on the ESOP loan—as well as interest payments on the ESOP loan—are deductible for federal income tax purposes. This treatment is different than other forms of debt, which only allow interest (and not principal) payments to be deductible for determining income taxes.

An example of the impact of the ESOP debt and the corresponding ESOP debt "tax shield" is presented in Table 1. In this transaction, let's assume that the ESOP acquired a 30 percent ownership interest in ABC Company.

The ESOP debt "tax shield" is calculated as the present value of future income tax savings associated with the tax deductibility of the ESOP debt principal payments. It is important to note that the ESOP debt "tax shield" declines over time as the ESOP debt is repaid.

**Table I**  
**ABC Company**  
**Equity Valuation**

	Before ESOP Transaction	After ESOP Transaction
Total Enterprise Value	\$50,000,000	\$50,000,000
Less: Interest-Bearing Debt	--	\$(15,000,000)
Add: ESOP Debt "Tax Shield"	--	\$2,500,000
Equals: Total Equity Value	\$50,000,000	\$37,500,000

Note: Total enterprise value includes both interest-bearing debt and all classes of equity.

### PRICE PROTECTION IN SECOND-STAGE ESOP TRANSACTIONS

Many ESOP transactions are consummated for less than 100 percent of company stock. This is due to a number of reasons. First, the selling business owner may be reluctant to give up total control of his or her company. Second, the company may not be able to finance a 100 percent acquisition transaction. As a result, ESOPs often acquire company stock in more than one transaction.

These multi-stage deals create a challenge related to the valuation of the different tranches of ESOP stock. This is because the debt created in a subsequent ESOP transaction is dilutive to the original ESOP and to its participants.

Those original ESOP participants who terminate their employment before the new ESOP debt is totally repaid risk having their shares redeemed at a price that is less than the fair market value indicated if the second ESOP transaction was not completed.

ESOP plan documents are often amended to provide ESOP participants in the original ESOP with a floor value or price protection that offsets dilution caused by the new ESOP. The floor value can be a fixed price. This fixed price is generally equal to the pretransaction value prior to the second stage transaction.

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*"As a result, ESOPs often acquire company stock in more than one transaction."*

However, this “floor value” is typically considered to be an unfair solution. This is because the original ESOP stockholders would not be subject to future business risk. And, this future business risk could reduce the value of all stockholders’ ownership interest over time.

A more appropriate way to treat the dilution caused by the second stage ESOP transaction is to value the original ESOP stock excluding the impact of the new ESOP debt. This procedure is dilutive to the new ESOP’s ownership interest. This is because some original ESOP participants will have their shares redeemed at a price that is above fair market value.

However, this solution is considered to be the most fair treatment of all ESOP participants. Accordingly, in determining the financial fairness of a pending second stage ESOP transaction, the financial advisor should consider the dilution caused by the price protection as part of its analysis.

It is important to note that the dilution caused by the price protection only affects those original ESOP participants who terminate their employment during the time period that the new ESOP debt exists. After the new ESOP debt is totally repaid, all ESOP participants are treated on an equal basis for valuation purposes.

As presented in Table II below, the impact of price protection is shown for both (1) the original pretransaction ESOP and (2) the new second-stage ESOP on the one-year anniversary of the second-stage transaction.

XYZ Company had no debt prior to the second stage ESOP transaction. In the second stage transaction, the ESOP acquired an additional 50 percent ownership interest in XYZ Company.

**Table II**  
**XYZ Company**  
**Equity Valuation**

	Before the First ESOP Transaction	After the Second Stage ESOP Transaction
Total Enterprise Value	\$50,000,000	\$50,000,000
Less: Interest-Bearing Debt	--	\$(22,500,000)
Less: Price Protection Liability[a]	--	\$(1,000,000)
Equals: Total Equity Value	\$50,000,000	\$26,500,000

[a] Price protection liability for the shares owed by the ESOP prior to the second stage transaction estimated based on (1) straight line amortization of the company’s debt obligations and (2) a repurchase liability study prepared by company management.  
Note: Total enterprise value includes both interest-bearing debt and all classes of equity.

## DISCOUNT FOR LACK OF MARKETABILITY

There is a significant difference between stock held in an ESOP, and otherwise identical closely held stock. One difference is that there is a mandatory repurchase obligation (often referred to as a “put” option) related to ESOP stock.

This put option requires the company sponsoring the ESOP to repurchase a participant’s shares upon certain events (such as retirement, death, or disability). Generally, a put option requires the company sponsoring an ESOP to repurchase shares at the current fair market value.

The effect of a put option is that it greatly improves the marketability of the underlying closely held company shares. Therefore, the put option greatly improves the liquidity of a retirement plan’s participant investment. Hence,

the existence of a put option will reduce—or often eliminate—the otherwise appropriate discount for a lack of marketability.

The selection of an appropriate discount for a lack of marketability for ESOP shares subject to a put option depends on several factors, including:

1. the payment terms of the put option,
2. the ESOP company’s historical record of redeeming ESOP shares,
3. studies related to the future repurchase of ESOP shares (the “repurchase obligation”), and
4. the company’s financial ability to redeem the shares.

However, the ultimate selection of a discount, if any, is often based on an analyst’s professional judgment and practical experience.

It is more likely today that a discount for lack of marketability will be applied to ESOP stock. This conclusion is the result of certain court cases as well as communications from the U.S. Department of Labor (the “DOL”). The DOL has indicated its preference that a discount for a lack of marketability should apply when an ESOP purchases employer corporation stock.

The effect of the sponsor company’s repurchase obligation should be considered in the valuation of ESOP stock. ESOP financial advisors should, at a minimum, consider management’s actions to make sure that the company has adequate funds to repurchase the ESOP stock. The ESOP financial advisor may recognize the effect of the repurchase obligation by selecting a higher discount for lack of marketability in the ESOP stock valuation.

*“This put option requires the company sponsoring the ESOP to repurchase a participant’s shares upon certain events . . .”*

*“The ESOP financial advisor may recognize the effect of the repurchase obligation by selecting a higher discount for lack of marketability. . . .”*

## ACQUISITIONS BY ESOP COMPANIES

ESOP companies, in an effort to increase revenue and profitability, often grow via acquisition. Generally, if the transaction is completed between independent parties subject to arm's-length negotiations and within a reasonable time period of the valuation date (less than one year) the transaction may have a neutral impact on the value of the company.

This conclusion is based on the assumption that the value of the assets acquired is equal to the value of the liabilities assumed.

Accordingly, the acquisition transaction has a neutral impact on the value of a company as of the date of the transaction. After a certain period of time however, the acquired company will be valued either separately or as part of the combined company using standard business valuation approaches.

This treatment is appropriate even if the ESOP acquirer is an S corporation. An S corporation ESOP provides an attractive ownership structure to facilitate acquisitions. This is because ESOP companies as tax exempt entities can acquire pretax dollars at after-tax costs.

However, based on the fair market value standard, the unique benefits to an ESOP company should not be considered in the valuation analysis. The real economic benefit that accrues to the company in the form of incrementally higher cash flow is accounted for within future valuations as the income tax benefit is realized.

The impact of acquisitions made by ESOP companies with regard to a variety of financial issues was highlighted in the recently decided *Armstrong v. Amsted Industries* case (No. 01 C 2963, 2004 U.S. Dist. LEXIS 14776 (N.D. Ill. July 29, 2004)). This will likely continue to be a key issue for ESOP trustees and for their financial and legal advisors.

## STOCK OPTIONS AND OTHER TYPES OF MANAGEMENT INCENTIVE COMPENSATION

The management of an ESOP company is often the single biggest factor that determines changes in the value of the ESOP's ownership interest in that company. Therefore, it is important that company management is provided with appropriate incentives to grow the business for all stockholders, including the ESOP.

Since participation in the ESOP alone does not generally provide appropriate incentives, stock options or other forms of

management perquisites are used to compensate company management for developing the business.

The valuation issue that needs to be considered with regard to management incentives is (1) the dilution, if any, caused by the management incentives and (2) how to quantify it.

The question of dilution is relatively straightforward. If the management incentives are not performance-based, then there is dilution that needs to be factored into the valuation analysis.

For example, if stock options vest based solely on the passage of time, management will be entitled to this additional form of compensation regardless of the company's change in value. However, if the options vest based on the achievement of certain performance targets (generally that are equal to or exceed current financial pro-

jections), then the value of the company will increase. This will benefit all stockholders including the ESOP.

The dilution in ownership percentage will generally be more than offset by the increased value. And, the management incentives will therefore not dilute the value of the ESOP stock.

If the analysis determines that the management perquisites are dilutive, the most accepted basis for quantifying their value is via a theoretical option pricing model such as Black-Scholes. A detailed discussion of Black-Scholes is beyond the scope of this article. However, the variables used to determine the value of stock options (as well as other forms of compensation based on the underlying value of the company) include:

1. current fair market value of company stock,
2. option price,
3. time to option expiration,
4. volatility of company stock, and
5. current interest rates.

## SUMMARY AND CONCLUSION

The valuation of ESOP stock is complicated. It includes many unique factors that are not considered in other business valuation assignments.

Accordingly, it is important that ESOP companies and ESOP trustees retain valuation analysts with specific expertise in the valuation of ESOP companies.

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