Reconciling the Current Employer Stock Valuation with Prior Stock Valuations

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The stock of closely held ESOP sponsor companies must be valued at least annually. In this valuation process, valuation analysts (and other interested parties) often consider how the annual employer stock value conclusions compare year to year. The U.S. Department of Labor, in its audits of these plans, pays close attention to how the employer stock valuations change from year to year, in terms of both value conclusions and valuation methodology. This discussion summarizes the need for the ESOP financial adviser to carefully document the yearly employer stock valuation changes. And, this discussion suggests financial adviser procedures for such documentation.

Introduction

Closely held corporation employer stock that is held by an employee stock ownership plan (ESOP) must be valued at least annually. The annual employer stock valuation is used for plan administration purposes, such as for providing distributions to departing plan participants.

The annual employer stock valuation is also submitted to the U.S. Department of Labor (DOL) as a part of the Form 5500 submission. Form 5500 is used to satisfy the annual reporting requirement under Title I and Title IV of the Employee Retirement Income Security Act (ERISA).

The consistent valuation each year of the employer stock held by the ESOP is important to the long-term success of the plan. The consistent employer stock valuation can also help to protect the sponsor company in the event of plan scrutiny by plan participants and/or by regulating agencies.

However, it is likely that the employer stock values will change from year to year. It is important, therefore, that employer stock value changes are documented in the employer stock valuation report and are discussed with the ESOP trustee.

Changes in the employer stock valuation conclusion from one year to the next are inevitable. The public stock markets are constantly changing. Due to the impact of mergers and delistings, publicly traded guideline companies come and go.

The guideline merger and acquisition transactions used in the prior employer stock valuations become stale. And, the investment risk and expected return profile of the sponsor company may change over time. As a result, the employer stock value conclusion can change significantly, even over the course of a single year.

For these reasons, the current employer corporation stock valuation report will often include a reconciliation with past employer stock valuation conclusions.

This discussion summarizes the importance of consistency from one employer stock valuation to the next. This discussion summarizes the valuation methods and procedures that may help both the valuation analyst and the valuation report user (i.e., the ESOP trustee) to understand any changes in:

1. the valuation methods used,
2. the valuation pricing multiples selected,
3. the valuation discounts applied, and
4. other valuation variables.

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Background of the Employer Stock Value Reconciliation Issue

When the ESOP trustee or a sponsor company executive reviews the employer stock valuation report, he or she needs to be able to understand both its content and its intent. The valuation report reader needs to understand how the sponsor company stock value has changed compared to previous employer stock valuations.

The valuation analyst should be mindful of this report reader perspective as the analyst prepares the employer stock valuation report. Too often, the current employer stock valuation bears little relationship to the employer stock valuation prepared in past years. This lack of valuation report comparability and consistency can also occur when the sponsor company changes the plan's valuation analyst.

Changes in the ESOP Financial Adviser

A financial adviser who practices in the ESOP valuation discipline may be invited to "take over" the annual stock valuation assignment from another financial adviser. The reasons for the sponsor company's change in financial advisory firms can vary. Sometimes the prior valuation analyst simply goes out of business or retires.

Other times, the ESOP trustee or the sponsor company management simply wants "a fresh set of eyes." When such a change is contemplated, the transition to a new plan financial adviser should be undertaken with care.

When the new financial adviser reviews the previous employer stock valuation reports, he or she may find that there were significant changes from year to year. And, the new financial adviser may find that there was little or no explanation as to why the annual changes were made.

An Illustrative Example

In a recent case, a manufacturing company management encountered this exact situation. The sponsor company had established an ESOP in 2004. The sponsor company management decided to have company officers serve as the ESOP trustees.

In 2008, this sponsor company hired a new chief financial officer (CFO). The new CFO began to ask questions about the ESOP and about the annual employer stock valuations.

The new CFO studied the employer stock valuation reports for the past several years. He could not understand the significant valuation methodology changes from year to year. From his point of view, there appeared to be little relationship between the annual sponsor company stock valuations.

In comparing the employer stock valuation reports for 2008 and 2009, the CFO determined that different sets of valuation analysts from the same firm had prepared the two annual employer stock valuations. The CFO also noted that significantly different stock valuation methods were used in the two different employer stock valuation analyses.

Different valuation discounts had been applied in the different valuation reports, and the calculation of the sponsor company weighted cost of capital (WACC) differed materially between the years. Nonetheless, there was no explanation of these changes in the later employer stock valuation report.

In addition, there was no attempt in the current valuation report to provide the ESOP trustees with any kind of reconciliation with the prior annual employer stock valuation reports.

During this same time period, the DOL initiated an audit of this particular ESOP. The DOL auditors expressed particular concern about the significant changes in the employer stock valuations from year to year.

Without any documentation or explanation of these changes, the DOL auditors pressed for all of the employer stock valuation details. The DOL audit resulted in several weeks of examination and effort by the sponsor company management and by its financial advisers. Accordingly, the DOL audit was a costly exercise for the sponsor company.

Lessons Learned from This Illustrative Example

As a result of the DOL audit, the sponsor company hired an outside professional ESOP trustee and a new ESOP financial adviser. The result of the change was a revaluation of the employer stock and a reduction in the concluded fair market value of the employer stock.

After a presentation of the new employer stock valuation by the ESOP trustee, the sponsor company management concurred that the new stock valuation report made more sense. The sponsor company management had a much better understanding of what factors influenced the value of the sponsor company.

Exhibit 1
Building Materials Corporation Employer Stock Value
Year-Over-Year Valuation Comparison
As of December 31, 2009

Employer Stock Valuation Analysis	As of 12/31/05 $000s	As of 12/31/06 $000s	As of 12/31/07 $000s	As of 12/31/08 $000s	As of 12/31/09 $000s
Sponsor Company Business Enterprise Value Indications					
Discounted Cash Flow Method	$ 89,578	$ 101,600	$ 48,270	$ 37,400	$ 29,500
Guideline Publicly Traded Company Method	90,550	112,500	70,477	47,300	26,300
Guideline Merged & Acquired Company Method	88,748	102,700	67,278	43,000	28,100
Indicated Business Enterprise Value	$ 89,801	$ 106,180	$ 64,756	$ 41,620	$ 28,540
Less: Long-Term Debt Outstanding	(39,215)	(24,263)	(12,233)	(8,661)	(8,711)
Less: Company Repurchase Obligation	-	(5,767)	(3,786)	(2,000)	(1,700)
Indicated Total Shareholders' Equity Value on a Marketable, Controlling Ownership Interest Basis	50,586	76,150	48,737	30,959	18,129
Less: Discount for Lack of Marketability	(2,529)	(3,808)	(2,437)	(1,548)	(906)
Indicated Total Shareholders' Equity Value on a Nonmarketable, Controlling Ownership Interest Basis	48,057	72,343	46,300	29,411	17,220
Number of Shares Outstanding	487.5	487.5	487.5	487.5	487.5
Concluded Fair Market Value Per Share, on a Nonmarketable, Controlling Ownership Interest Basis (in $s)	$ 98.58	$ 148.00	$ 95.00	$ 60.30	$ 35.30
Implied Sponsor Company Valuation Pricing Multiples					
Indicated Business Enterprise Value / Revenue	0.71	0.72	0.67	0.73	0.97
Indicated Business Enterprise Value / Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA)	4.9	5.2	8.7	26.0	(6.55)

The DOL was satisfied with the actions taken by the sponsor company. Accordingly, the DOL closed the audit with a no action letter.

The sponsor company management believes that it is now on the right track with its ESOP. And, the sponsor company management now recognizes the importance of reconciling the employer stock valuations each year.

Reconciling the Current Employer Stock Valuations

The ESOP financial adviser should consider reconciling the results of the current employer stock valuation with the earlier employer stock valuations. The ESOP trustee and the sponsor company management team should be able to understand both how and why the value of the employer corporation stock changed over time.

Exhibit 2
Building Materials Corporation Employer Stock Value
Year-Over-Year Valuation Comparison
Comparative Analysis of Selected Valuation Variables
As of December 31, 2009

Employer Stock Valuation Variables Analysis	As of 12/31/05 $000s	As of 12/31/06 $000s	As of 12/31/07 $000s	As of 12/31/08 $000s	As of 12/31/09 $000s
VALUATION METHOD WEIGHTING					
Discounted Cash Flow Method	40%	40%	20%	40%	70%
Guideline Publicly Traded Company Method	40%	40%	40%	20%	30%
Guideline Merged & Acquired Company Method	20%	20%	40%	40%	0%
VALUATION DISCOUNTS/PREMIUMS					
Discount for Lack of Marketability	-5%	-5%	-5%	-5%	-5%
Discount for Lack of Control	n/a	n/a	n/a	n/a	n/a
Ownership Control Price Premium	10.0%	10.0%	10.0%	10.0%	10%
WACC & DIRECT CAPITALIZATION RATE					
Ke (Cost of Equity Capital)	16.8%	15.0%	14.0%	13.8%	19.0%
Company-Specific Equity Risk Premium	2%	0%	0%	0%	4%
Beta	NM	NM	0.80	0.87	1.30
Kd (Cost of Debt Capital)	6.0%	6.3%	6.7%	5.1%	6.4%
Income Tax Rate	39%	39%	38%	38%	38%
We (% of Equity Capital)	60%	60%	60%	60%	60%
Wd (% of Debt Capital)	40%	40%	40%	40%	40%
Expected Long-Term Growth Rate	3.5%	4.0%	5.0%	5.0%	4.0%
BALANCE SHEET DATA					
Long-Term Debt	$ 39,215	$ 35,797	$ 32,001	$ 27,765	$ 21,215
- Cash Balance	$ -	$ (11,535)	$ (19,767)	$ (20,249)	$ (12,505)
= Net Long-Term Debt	$ 39,215	$ 24,263	$ 12,233	$ 7,515	$ 8,711
INCOME STATEMENT DATA					
Net Revenue	$ 146,688	$ 96,111	$ 57,308	$ 57,308	$ 29,545
Normalized EBITDA [a]	$ 15,749	$ 5,635	$ (255)	$ 1,601	$ (4,356)
GUIDELINE PUBLICLY TRADED COMPANY PRICING MULTIPLES					
LTM Pricing Multiples					
EBITDA Pricing Multiple [a]	4.8	5.0	7.0	4.0	-
Revenue Pricing Multiple	0.50	0.70	0.30	0.25	0.65
Mean of Period Pricing Multiples					
EBITDA Pricing Multiple [a]	9.5	8.0	6.0	6.0	9.0
Revenue Pricing Multiple	0.60	0.80	0.30	0.30	0.47
GUIDELINE MERGED & ACQUIRED COMPANY PRICING MULTIPLES					
EBITDA Pricing Multiple [a]	5.5	10.0	NM	6.0	NM
Revenue Pricing Multiple	0.7	0.70	0.70	0.75	0.95

a. EBITDA = Earnings before interest, taxes, depreciation, and amortization.

In this way, an appropriate explanation can be provided in the stock valuation report to the plan participants, as well as to the plan regulators. One way to accomplish this objective is through the use of comparative exhibits in the employer stock valuation report.

Building Materials Corporation Illustrative Example

Exhibit 1 presents a summary of the employer stock valuation results over a five-year period for Building Materials Corporation. Building Materials Corporation is a hypothetical building materials sponsor company.

This illustrative exhibit provides the valuation report reader with a summary comparison of the results of the employer stock valuation over a five-year period.

Exhibit 2 contains more information related to how the employer stock valuations were completed each year. These illustrative exhibits provide information related to the following:

1. the valuation methods used
2. the valuation discounts and premiums applied
3. the WACC data used
4. other valuation variable information.

The idea is to provide the valuation report reader with a basic understanding of which factors are driving the change in employer stock value from period to period.

The hypothetical sponsor company illustrated in the two exhibits serves the new home market in a large metropolitan area. That market has enjoyed double-digit housing growth over the last 15 years.

Let's assume that Building Materials Corporation provides value-added building materials, such as windows and doors, to that market. Building Materials Corporation is a conservatively managed business. And, the sponsor company has maintained a strong cash position in recent years.

Building Materials Corporation Illustrative Analysis

Building Materials Corporation installed an ESOP in 1999, with the company founder providing all of the financing in a 100 percent employer stock sale. As the exhibits suggest, Building Materials Corporation was hit particularly hard by the recent decline in the new home construction market.

The Building Materials Corporation business enterprise value increased during the first few years after its ESOP formation. However, there was a decline in the employer corporation business enterprise value beginning in 2007.

The Building Materials Corporation business enterprise value decreased from a high of $106,180,000 in 2006 to a low of $28,540,000 as of December 31, 2009.

Therefore, it was important for both the plan trustee and the Building Materials Corporation management to understand the impact of the housing market and the economy on the employer stock value.

Exhibit 2 provides more information regarding the annual employer stock valuation. Exhibit 2 compares:

1. the weighting of the selected business valuation approaches,
2. the valuation discounts and premiums applied,
3. the calculation of the WACC and the direct capitalization rates,
4. the balance sheet and income statement data, and
5. the valuation pricing multiples resulting from the stock valuation each year.

Building Materials Corporation Example Conclusion

With this exhibit, the Building Materials Corporation management:

1. can ask specific questions of the valuation analyst and
2. can develop an understanding of the employer stock valuation.

For this building materials sponsor company, the cause of the loss in employer stock value was obvious. However, the use of comparative data was important in communicating the employer stock valuation results throughout the sponsor company organization.

The use of the year-over-year exhibits is particularly useful at the presentation of the employer stock valuation report to the ESOP participants. With the reconciliation exhibits, the ESOP trustee obtains an accurate historical perspective on the employer corporation shareholder value.

Exhibit 3
Building Materials Corporation Employer Stock Value
Sponsor Company Management-Prepared Financial Projections
Year-Over-Year Comparison
As of December 31, 2009

Financial Fundamental	Valuation As of Date	FYE 2005 $000s	FYE 2006 $000s	FYE 2007 $000s	FYE 2008 $000s	FYE 2009 $000s	FYE 2010 $000s	FYE 2011 $000s	FYE 2012 $000s	FYE 2013 $000s	FYE 2014 $000s
Revenue	Dec-04	126,575	132,904	139,549	146,526	153,853					
	Dec-05	**126,783**	130,100	134,654	139,366	144,244	149,293				
	Dec-06		**146,688**	145,975	156,193	167,127	178,826	191,343			
	Dec-07			**96,111**	95,505	100,280	105,294	110,559	116,087		
	Dec-08				**57,308**	53,382	58,721	64,593	72,344	81,025	
	Dec-09					**29,545**	36,406	47,328	56,794	68,152	81,783
EBITDA [a]	Dec-04	13,700	14,208	14,918	15,663	16,447					
	Dec-05	**13,846**	15,314	16,138	16,703	17,288	17,893				
	Dec-06		**15,749**	11,656	12,526	13,584	14,717	15,929			
	Dec-07			**5,635**	4,812	4,902	5,497	6,036	6,592		
	Dec-08				**(255)**	2,587	2,466	2,820	3,470	4,198	
	Dec-09					**(4,356)**	1,140	2,528	4,569	7,375	11,478

What the financial fundamentals were projected to be for 2009.

What financial fundamentals were actually achieved by the sponsor company in 2009.

* Actual financial results are highlighted.

a. Earnings before interest, taxes, depreciation, and amortization.

The ESOP trustee can use the exhibits to discuss the changes in the employer corporation value with the sponsor company management. The result of such discussions can be:

1. an understanding of the changes to shareholder value and
2. the consideration of what actions can be taken to impact the employer corporation value in the future.

Exhibit 3 presents an illustrative example of one tool that the valuation analyst can use in the employer stock valuation reconciliation process. This exhibit tracks the Building Materials Corporation financial projections compared to the actual Building Materials Corporation operating results achieved year by year.

In this Building Materials Corporation illustrative example, both (1) revenue and (2) earnings before interest, taxes, depreciation, and amortization (EBITDA) are tracked.

The Building Materials Corporation management expected to earn $53,382,000 in revenue for 2009 when the projections were developed at the end of 2008.

In fact, Building Materials Corporation generated only $29,545,000 in revenue in 2009. There was a similar 2009 shortfall in EBITDA. And, based on the performance shortfalls in these financial fundamentals, the reason for the decline in the employer stock value became evident.

Lessons Learned from the Building Materials Corporation Illustrative Example

In the years prior to the economic downturn and the new home construction market downturn, the Building Materials Corporation management had done a good job in projecting the company financial performance. The Building Materials Corporation management projections were particularly accurate in years prior to 2007.

In 2006, for example, the Building Materials Corporation management had projected EBITDA of $15,314,000, and the sponsor company had actually achieved EBITDA of $15,749,000.

The exhibit was helpful to Building Materials Corporation management and to the ESOP trustee. This is because the exhibit showed them how the projected company results compared to actual company performance over time.

This example may be extreme. However, it helps to illustrate the importance of the reconciliation in the employer stock valuation process.

In 2010, Building Materials Corporation began the turnaround to sustained profitability. This turnaround was achieved despite a still somewhat stagnant market. It will be interesting to track this sponsor company performance in the employer stock valuations prepared in the coming years.

Benefits to the Valuation Analyst—And to the Employer Stock Valuation Report Reader

The emphasis on tracking employer stock valuation data historically helps the valuation analyst—and it helps the sponsor company management. The valuation analyst can look at these data to make current decisions.

Equally important, the valuation analyst should recognize that any material changes in the employer stock valuation from one year to the next are subject to regulatory scrutiny. This scrutiny is not just from the ESOP trustees, but also from the DOL and the IRS.

Therefore all material employer stock value changes should typically be explained in the employer stock valuation report.

Exhibits that illustrate the historical changes in the annual employer stock valuation make it easier for the plan administrators as well. When the ESOP plan participants request diversification, retire, or otherwise leave the sponsor company, there may be questions related to the current value of the sponsor company stock.

These employer stock value tracking exhibits make it easier to explain employer stock valuation changes and, hopefully, to give the departing plan participants the sense that the employer stock valuation process is fair and equitable.

Summary and Conclusion

The changes in the U.S. economy beginning in 2008 underscore the need for employer stock valuations that consider a historical context. The employer stock value decreases in many sponsor companies have been large. And, these sponsor company stock value decreases have had an impact on individual participant plan account balances.

Understanding how the employer stock valuation has changed from previous periods is important to the plan trustee and to the sponsor company management.

Continuity in the annual sponsor company stock valuation is important to the long-term success of the ESOP. Sponsor company managements should request that a reconciliation process be considered as part of the annual employer stock valuation.

The employer stock value reconciliation process may include an explanation of changes that have occurred in the employer stock valuation from the previous year.

The valuation analyst tools summarized in this discussion may prove to be helpful in that employer stock value reconciliation process. Using these illustrative exhibits in an employer stock valuation may simplify the process of:

1. explaining the current employer stock valuation,
2. describing the reasons for the changes in the employer stock values over time, and
2. administering the plan.

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