MERCER CAPITAL

INSIGHTS ON

EMPLOYEE STOCK OWNERSHIP PLANS

ESOP FACTS & FIGURES

REACH	STRUCTURE	INFLUENCE
There are approximately 11,500 ESOPs in place in the U.S., covering 10 million employees (10% of the private sector workforce). These employees draw in excess of 3% of their total compensation from ESOP contributions.	Approximately 4,000 ESOP companies are majority-owned by the ESOP. Approximately 2,500 are 100% owned by the ESOP. About 2% of ESOP companies are unionized.	A majority of ESOP companies have other retirement plans, such as defined benefit pension plans or 401(k) plans,to supplement their ESOP.
About 330 ESOPs - 3% - are in publicly traded companies. However, these companies employ just under 50% of the nation's 10 million employee owners.	At least 75% of ESOP companies are or were leveraged, meaning they used borrowed funds to acquire the employer securities held by the ESOP trustee.	Of the 11,500 employee-owned companies nationwide, fewer than 2% were financially distressed when they established their ESOP.
While ESOPs are found in all industries, more than 25% of them are in the manufacturing sector.	An estimated 7,000 of the 11,500 companies have ESOPs that are large enough to be a major factor in the corporation's strategy and culture.	Total assets owned by U.S. ESOPs is estimated to be $800 billion at the end of 2006.

MERCER CAPITAL'S
ESOP VALUATION SERVICES

Mercer Capital understands ESOPs because we are an employee-owned firm. Our ESOP was installed in January 2006.

We provide annual appraisals for ESOP trustees as well as ESOP formation and adequate consideration analyses, feasibility valuation studies, fairness opinions and other valuation-related services for ESOP companies and financial institutions.

We bring over 30 years of valuation experience to every ESOP engagement. The stability of our staff and our long-standing relationships with clients assure consistency of the valuation methodology and the quality of analysis for which we are known.

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THE USE OF THE INDEPENDENT FINANCIAL ADVISOR IN ESOP TRANSACTIONS

The complexity of transactions involving the use of Employee Stock Ownership Plans (ESOPs) and the rising sensitivity to fiduciary responsibilities has led many plan fiduciaries to seek the advice of independent financial advisors when important transactions occur. Examples include unleveraged purchases and sales of stock, leveraged purchase of shares, the use of hybrid securities, and multi-investor buyouts. This article describes the role and qualifications of the financial advisor, the primary factors in the development of financial advisory opinions, and some practical issues related to the decision by the trustee to hire an advisor.

ESOPs have been part of the corporate finance scene for more than twenty years. While the level of activity in the public markets has abated in recent years, transactions continue to occur in the less visible venue of the closely held company. Improving corporate profitability and greater availability of bank loans has lead to a resurgence in transactions. Notwithstanding the relative degree of complexity of a given transaction, consideration should be given to the use of an independent financial advisor.

Why is The Financial Advisor to The ESOP Important?

Over the years, a number of refinements and changes have occurred in the role of the various players in completing a transaction involving an ESOP. The Department of Labor (DOL), as the government agency responsible for monitoring compliance with the Employee Retirement Income Security Act of 1974 (ERISA), the Internal Revenue Service (IRS), and state and federal courts have increasingly focused on the role of the fiduciary in ESOP transactions. For example, the IRS periodically tightens up its procedures with new announcements such as Announcement 92-182 - Employee Plans Examination Guidelines and Announcement 95-33-Examination Guideline on Leveraged ESOPs.

A 1993 federal district court case, *Reich v. Valley National Bank of Arizona*, more commonly known as the "Kroy case," further heightened the potential responsibilities of the plan fiduciary and the financial advisor. A discussion of *Kroy* is outside the scope of this article, but suffice it say that it is essential that ESOP fiduciaries and advisors must understand its implications.

The effect of all of this has been to clarify and often increase the responsibilities of plan fiduciaries, because they are obligated to act prudently and solely in the interest of the plan participants. One way to meet those responsibilities is to use an independent financial advisor to address questions of adequate consideration and fairness.

Who Are The Players in an ESOP Transaction?

A transaction involving an ESOP can have the following participants to the purchasing and selling parties:

» An independent fiduciary (or other trustee) for the ESOP;

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- An independent legal counsel for the ESOP;
- An independent appraiser of shares to be purchased;
- An independent financial advisor for the ESOP; and,
- Legal counsel and possibly financial advisors for other buyers (e.g., management).

It may well be in smaller deals that several of the above roles are filled by the same person or entity. However, this duplication of roles raises the fiduciary's risk profile, particularly if the ESOP was later determined to be inadequately represented. A distinction should be drawn between an independent appraiser and an independent financial advisor. Although this role may be the same individual or company, the appraiser makes an independent determination of the fair market value of the company's shares and the financial advisor assesses the overall fairness of the transaction, including the pricing and terms. This article attempts to focus on the overall broader responsibility of the financial advisor (whether or not the advisor is an appraiser also) rather than discussing each consultant and their individual roles and responsibilities.

What Are The Responsibilities of The Financial Advisor?

The financial advisor acts as a financial consultant to the fiduciary. The role and responsibility of the financial advisor can be categorized as follows:

- Determine the fair market value of the company's shares;
- Evaluate the transaction from a financial point of view;
- Advise the fiduciary during negotiations and structuring of the transaction; and,
- Render the necessary opinions of fair market value and fairness from a financial point of view and provide suitable documentation for each.
- Documentation of the opinions is particularly important because some of them are required by law. The relevant factors in reaching the conclusion of value and fairness should be carefully articulated and supported.

What Are The Qualifications of The Financial Advisor?

The qualifications of the financial advisor are very important. Specific factors to consider include:

- General business valuation experience and credentials;
- Familiarity with the type of transaction;
- Knowledge of ERISA and other applicable regulations;
- Adequacy of resources to complete the assignment; and,
- Reputation for fairness, integrity and independence.

The financial advisor should be familiar with a wide range of valuation techniques, including those considered most accepted and utilized in the industry. Knowledge of the financial markets and accepted valuation techniques is also very important. "Rules of thumb" and other more generalized methods of valuation are likely to prove less useful in a complex ESOP transaction.

Fair Market Value and The General Concept of "Fairness"

The determination of fair market value of the stock is a crucial question because it is required; yet it is sometimes the easiest portion of the assignment. Fairness can be a much more difficult concept, particularly when a leveraged transaction is involved. It is vitally important that the ESOP and its participants be treated equitably in relationship to other shareholders. The test of financial fairness can be divided into two broad categories: (1) valuation and (2) allocation of equity among the owners.

The issue of valuation arises from ERISA's mandate that the ESOP cannot pay more than adequate consideration for the securities it acquires or sell securities for less than adequate consideration. It can however, pay less and sell for more. As part of the test of adequate consideration, the financial advisor must determine the fair market value of the securities. It is incumbent upon the appraiser to look at valuation from the perspective of the interest being sold (or bought) as well as the structure of the transaction.

The fairness of the transaction from a financial point of view requires an analysis of fair market value in the context of the transaction, as well as the overall treatment of the ESOP in relationship to other participants in a deal. Major questions often relate to allocating equity when shares are purchased in a multi-investor buyout, or to allocating the sales proceeds when the consideration paid includes cash, stock, notes receivable, contingent deferred payments, and non-compete or employment agreements.

The allocation of equity can be a very complex process in a multi-investor leveraged ESOP. Transactions involving cash equity at the time of the purchase by the ESOP are much more straightforward because all of the parties are purchasing their securities with the same "currency." The use of debt instruments adds substantial complexity because equity interests must be allocated appropriately.

The various methods of equity allocation have not been fully agreed to in the financial, regulatory, and legal communities; therefore the reader should be aware of possible philosophical differences that can lead to radically different conclusions.

Fairness Opinions and ESOP Transactions

The issue of the fairness of a transaction to all of the parties involved is often addressed by obtaining a fairness opinion from the financial advisor to the transaction. While a fairness opinion is not required in every transaction, there are certain situations in which ESOP fiduciaries and participants would benefit from an independent opinion of the transaction. The fairness opinion, which is a document that states whether or not a proposed transaction is fair from a financial viewpoint, provides a safe harbor to the ESOP fiduciary from charges of uninformed decision-making, violations of the business judgment rule, and conflicts of interest. It also, more importantly, protects the rights of the participants and enables the fiduciary to negotiate the best possible deal for the ESOP. Its purpose is to provide an objective standard against which directors, shareholders, fiduciaries, and other interested parties may measure proposals and opportunities presented to the company. The facts of a particular proposal may lead the parties involved to believe that an analysis of other alternatives should be considered. Circumstances in which it would be prudent to obtain a fairness opinion include:

- An offer in which competing bids that differ in structure, pricing and/or terms is received, which would require an interpretation and clarification of the effective price, considering all factors.
- Transactions between the ESOP and a party in interest (i.e., a prohibited transaction); particularly when the seller remains in the role of a significant owner or manager.
- An offer is unexpected and unsolicited or hostile. This differs from the questions that would arise in a situation where an offer has been solicited and several competing bids have been received.
- There is a lack of agreement among the directors as to whether an offer is adequate.
- Judgment is needed about the treatment of ESOP-related debt and an equitable employee benefit going forward.
- There are various levels of shareholder sophistication, and it must be demonstrated that efforts were expended to assure fairness to all parties involved.
- An offer is complex, or differing offers have been made to differing classes of shareholders.
- The company has experienced a recent history of poor financial performance.

The scope of a fairness opinion analysis is broad and extends beyond the rigid or "canned" analysis of a computer-generated financial model. The financial advisor is retained to assist the fiduciary in determining whether an offer is made to the shareholders at a fair price — a determination that requires an examination of the present and future prospects for the company; the existence of other alternatives; the ability to obtain financing to complete the transaction; and the overall effect of a proposal on employees, customers, suppliers, creditors, and the community in the case of small, closely held companies.

The fairness opinion document is generally a short document, typically a letter, but may vary in length and detail and is dependent on the complexity of the transaction, the financial advisor, and the needs of the fiduciary. Generally the document is a letter addressed to the fiduciary that outlines the major considerations of the opinion, describes the due diligence process including all of the documents reviewed, and offers the advisor's opinion of the fairness of the transaction from a financial viewpoint. While the document itself may be short, the supporting documentation is substantial, and reflects the degree to which the proposed transaction was analyzed.

Evaluating the financial aspects of a tender offer or the acquisition of shares by an ESOP is a challenging and complex task. The expert retained to render a fairness opinion must be aware of IRS and DOL regulations, ERISA provisions, specific plan provisions, accepted investment analysis practices, the specific facts and circumstances surrounding the transaction, and furthermore must sometimes be willing to protect the interest of the ESOP participants through active negotiating of terms and pricing.

Observations From Experience

The authors' experience as financial advisors to ESOP fiduciaries has led to a number of practical observations. Following are useful considerations for a fiduciary when the ESOP is the purchasing entity.

» Properly allocating equity in a multi-investor deal can be difficult, particularly if the non-ESOP participants (i.e., management) have preconceived notions or objectives about the amount of equity they should receive outside the ESOP. The trustee will receive assistance in protecting the interests of the plan participants by using an independent advisor.

» The calculations needed to conduct an equity allocation analysis in a multi-investor buyout are performed in financial models that are not intuitively obvious. The concepts are complex and the assumptions require substantial documentary support. Experience is an important factor in determining the appropriateness and reasonableness of the conclusions.

» The presence of arms' length negotiations is a question of fact. Quite often the selling shareholder remains with the company, typically as a senior manager, in a continuing ownership position. This person may also be a fiduciary of the ESOP, which further complicates matters. If these conditions are present, it is incumbent on the financial advisor to document carefully the determination of fair market value.

» The financial advisor and the fiduciaries must also consider the issue of prudence of the investment. Is it a good idea to make this investment in a retirement plan?

Following are comments from the perspective of representing the ESOP in a sale situation.

» The history of prior appraisals must be considered. What does one do if the non-marketable minority interests appraisals of previous years show a greater fair market value than the sales price of the entire company without any intervening explanatory event? It may be impossible to reconcile the market reality of the sale of the business with an earlier valuation that existed when shares were sold to the ESOP.

» The proceeds of the sale must be allocated fairly to all the selling shareholders. The ESOP cannot be treated less favorably than other shareholders. This can be complicated by the issue of expenses and the presence of stock, notes, or outside agreements as consideration for the sale.

» The prudence of the sale should also be considered. Is the timing of the sale correct? For example, would it be better to wait until improving trends in operations reflect better financial performance and presumably greater value?

» From time to time, the legal counsel for the company will also be legal counsel for the ESOP. At such times, the financial advisor is operating without independent counsel representing the ESOP, which requires that the advisor be cognizant of what role the attorney is playing and who the attorney is representing.

» The adequacy of the consideration paid is crucial. If the financial advisor is brought into the transaction after a preliminary deal is struck, then it will be very awkward when the necessary adjustments in price are proposed. This circumstance presents the greatest single reason for bringing the financial advisor into the transaction as early as possible.

» Non-compete and employment agreements are frequently necessary to facilitate the sale of a closely held business. The allocation of the real purchase price must be fair to the ESOP participants.

Conclusion

Regulatory, legal and business trends are all moving toward increased responsibilities for ESOP fiduciaries. Fiduciaries must demand quality work from ESOP financial advisors and be in a position to recognize pitfalls before they occur. At the same time, it is important for the fiduciaries to recognize that financial advice can be of great benefit in starting transactions and providing comfort as they perform their fiduciary responsibilities.

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VALUATION ISSUES FOR ESOP FIDUCIARIES

Solicit war stories from an experienced ESOP advisor, and you will likely hear tales of regret and intrigue, often featuring ESOP trustees who fell short of fulfilling their fiduciary obligations. There are countless victims of bad advice, ineptitude, and fraud in the ESOP universe. The question for fiduciaries in such cases is, "Did you exercise the prudence required of your position?" The answer, in hindsight, is usually "no."

In recent years, there has been a significant increase in the scrutiny of process and in the propriety of conduct surrounding ESOPs and their fiduciaries. In response, boards of directors, ESOP trustees (both inside trustees and third-party trustees), and ESOP company shareholders are seeking more skilled and experienced service providers to enhance their understanding of the valuation process and to improve the credibility of valuations. If you are an ESOP trustee, a board director, a chief executive, or a selling shareholder in an ESOP company, the ante for prudent decision-making is rising rapidly. If you are an ESOP stakeholder in more than one capacity, you may face a challenging situation.

While the realm of a trustee is extensive, valuation and fairness are of particular concern to fiduciaries. Much has been written concerning Enron and other egregious cases of corporate malfeasance. As if greed alone were not sufficiently compelling, the demographic onslaught of plan participants requiring diversification or retirement is sure to draw the attention of regulators and/or the curiosity of employees. Compounding these concerns are the competing liquidity needs of non-ESOP shareholders who may be calling on finite resources to address their own needs. Additionally, the macro economy and many of its subset industries are experiencing changes in fundamental and cyclical behavior resulting in greater volatility of performance. In the midst of all this turbulence, a healthy dose of examination is required for existing and would be ESOP fiduciaries.

The following list of considerations is provided to inspire self-investigation. Do not skim past sections or cut short your reading based on your specific circumstances, because each phase of an ESOP's life is based on its previous phases.

Newly Forming ESOPs

Ideally, the installation of an ESOP occurs after considerable research. However, the interactive nature of valuation and financing arrangements, coupled with the political and financial pressures of getting a transaction done, creates certain pressures. Commonly, the first call placed is to an appraisal firm. After all, the appraiser is there to maximize the valuation—right? Surely, the appraiser is fully aware of changes in legislation and is trained in all ERISA-related matters—right? After all, the appraiser is providing the bank an opinion on which it can place its full reliance—right? The unconditional answer to these questions is "wrong."

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Feasibility is often the first step in determining whether an ESOP is achievable. Feasibility, from a financial perspective, generally involves estimating the value of shares to be sold and assessing an ESOP's (and a sponsor company's) ability to service the debt incurred based on the pool of compensation available from qualifying participants. Valuation firms differ in their approach and involvement in the process. If the appraisal firm assisting in the feasibility process is to continue as the ESOP trustee's appraiser going forward, then it is vital to not only define but to confine such appraiser's role. Value-maximizing exercises are in direct conflict with the DOL's charge that an ESOP tender no more than adequate consideration for the interest it purchases. Make sure the appraiser is not tainted with goal-oriented pressures that typically abound. The appraiser's retention letter should appropriately define the engagement and the financial perspective from which any opinion is developed and any service rendered. An awareness of how today's actions and processes will be viewed in the future is a useful perspective to contemplate. Yes, we live in a litigious world; however, the financial and ideological aims of an ESOP should be sufficiently important to inspire nothing but the utmost precision of process and documentation when forming an ESOP. Of course, no amount of administration will overcome the number one cause of ESOP failure—over-valuation.

Existing ESOPs—Business as Usual?

The valuation resulted in a doable number; shareholders were satisfied; the ESOP is installed; and all seems fine on the ESOP frontier. Assuming business fundamentals remain relatively on track with expectations, everything should be fine—right? However, seemingly out of the blue (but in fact foreseeable), the company must start dealing with diversification and post-termination distributions, but the original ESOP debt is not yet retired. This failure to anticipate diversification and termination needs often results in unforeseen financial complications. Simultaneously, the business model may require investment that is difficult to address because of pre-existing requirements to service ESOP debt and to deal with other unanticipated circumstances. ESOP fiduciaries cannot lower their antenna during the maturation of the plan. Every contingent requirement of the ESOP and the business must be reasonably anticipated.

ESOP Terminations

The decision to sell an ESOP company (or not to sell, as the case may be), particularly one in which an ESOP owns a controlling interest, requires significant procedural discipline. Strategic decisions to market an ESOP company for sale, to respond to an acquisitive probe, or to pursue a merger are perhaps the most difficult scenarios an ESOP fiduciary faces. Plan terminations involve high-stakes decision-making and require heavy documentation. Issues of fairness should be central in all such situations. Senior officers and trustees must be fully informed concerning the financial and nonfinancial ramifications of any transaction.

Determining an appropriate course of action for a diverse pool of participants can be difficult. Mature plans with near-term retirees may prefer a sale, while others may not. There are many scenarios where the interests of the ESOP are anything but uniform. Reconciling an ESOP's prerogatives with the business model and its long-term strategy is potentially a mind-boggling exercise. Ultimately, trustees must arm themselves with adequate representation and guidance from qualified advisors.

Appraiser Opinion = Trustee Fact

Does the reliance by an ESOP fiduciary upon an appraisal opinion relieve the trustee of responsibility for that opinion? Ultimately, no. The appraiser's opinion is an instrument designed to advise the trustee. Any opinion relied upon from an advisor becomes the opinion of the trustee. As such, trustees cannot fail to provide meaningful review and input, in a totally dispassionate manner, to appraisers in the process of installing, maintaining, or terminating an ESOP. Trustees who fail to recognize potentially controversial appraisal adjustments and treatments place themselves, and those entrusted to their care, in great peril. With that in mind, the following list of valuation-oriented inquiries should be useful in understanding some common considerations when reviewing an appraisal opinion.

Is the Appraisal Firm Independent?

While many appraisers perform more than just ESOP-related services for sponsor companies, it is vital that no conflict of interest exist. Differing situations require differing thresholds of sensitivity concerning conflict of interest. Prior exposure to a given business by way of non ESOP work can result in a more informed appraisal opinion. Conversely, previous work products performed for differing reasons should not reflect opposing rationales or unreasonable departures from analytical consistency.

Conflicts of interest can be difficult to identify. Many appraisal firms provide gift and estate tax appraisals for non-ESOP shareholders of sponsor companies. In fact, shareholder liquidity and succession planning often give rise to ESOPs. Accordingly, appraisal firms with a legacy of work prior to an ESOP become natural ESOP appraiser candidates upon plan installation. Similarly, some appraisal firms provide investment banking and other advisory services which sponsor companies may have used prior to an ESOP. It is important to assess all prior engagements and to be aware of the purpose for and the analytical content of previous valuations performed by firms proposing to render ESOP valuation services.

As a general rule, firms rendering contingent fee services such as sell side representation for ESOP companies should likely be excluded from future ESOP-related work and particularly from rendering fairness opinions related to their engagements. Occasionally, companies studying the feasibility of an ESOP determine that certain strategic actions, such as the sale of a subsidiary or certain assets, are desirable or needed before an ESOP is optimal or even possible. These actions often require advisory services and such prior work need not automatically exclude an appraiser from rendering ESOP valuation services.

In the valuation world, the devil of conflict can be in the details. Conflict of interest is less often related to the rendering of multiple services by a single provider and more often manifests itself through inappropriate adjustments, assumptions, and/or methodologies which are in direct conflict with common sense, informed judgment and reasonableness. Therefore, conflict of interest extends beyond the breadth of service rendered by a given provider and is often a case of incompetence or unwitting advocacy. As with the practice of law and medicine, specialization in services is a major part of the appraisal profession. However, if an appraisal firm is too limited in the scope of its practice, too narrow in its industry expertise or limited in its valuation expertise, then a trustee may be well advised to look elsewhere for valuation services. Sometimes, companies outgrow their appraisal firms and need additional expertise.

Does the Appraisal Report Reflect an Accurate and Reasonably Complete Description of the Company?

Frequently, poorly crafted opinions are revealed before a single number is discussed. Trustees should fully recognize the industry, economic, and company-specific aspects of the sponsor company in the appraisal report. Lack of sufficient report documentation can be indicative of insufficient due diligence and of limited comprehension of facts that may be necessary to make vital valuation assumptions.

Has the ESOP Pool Been Examined for Diversification and Retirement Needs?

That next installment sale may be in direct conflict with meeting the needs of the existing plan participants. Liquidity at the company level may be required as a sinking fund for emerging liability issues. Absent such liquidity, borrowing capacity may be required to service the ESOP as opposed to redeeming the next shareholder desiring liquidity.

Repurchase obligation studies on a regular basis are recommended even for ESOPs with a relatively young work force. Such studies can provide awareness of long-term issues which may overlap with future strategic goals. Sure signs of the need for an emerging liability study include: a maturing plan in which the ESOP's debt has been or is near retirement; when share allocations are to participants older than 55 years of age; high employee turnover; and/or a plan with near term retirees.

Has the Company Experienced Volatile and/or Declining Performance? How Has the Valuation Report Changed to Reflect Any Such Impact on Value?

Remember, the valuation is ultimately the responsibility of the trustee. The appraiser is essentially an advisor whose work the trustee must be able to understand, scrutinize, and ultimately promulgate as his or her own opinion of value. While hindsight always brings previously unrealized clarity, appraisers and trustees must be able to comprehend the future implications of changing financial performance and position. While expectations can change and certain things are unknowable, appraisers and trustees must not be guilty of fable by either omission or commission. Do not let the ESOP valuation constitute the flattery of the fox that bluffed the cheese from the crow. In the context of changing conditions, do not let your ESOP valuation report become a fable as it seeks consistency with past reports and downplays the severity of a real threat. Shortsighted gains and procrastination will ultimately come back to haunt shareholders and ESOP participants.

Does the Valuation Report Provide Reconciliation With Prior Opinions?

Road maps are helpful, particularly for those who are determined not to pull over and ask for directions. Charting the trends of the valuation and its underlying assumptions is a useful exercise and often provides the best platform for review and feedback. If an appraiser cannot adequately clarify and convince the trustee concerning an opinion, how will he or she do so with the DOL or other stakeholders?

Does the Appraiser Provide Adequate Support and/or Discussion for Changes in Methods and/or Critical Assumptions from One Report to the Next?

Analytical methods should not come or go without good reason. Valuation practitioners must reserve the right to improve in their craft, but any change to valuation methodology, particularly one that could have the appearance of obfuscation or advocacy, must be satisfactorily explained and documented.

Does Each Annual Report Stand on its Own While Also Reflecting the Evolution of Reporting and Analytical Standards?

It is amazing the lengths we go to rationalize replacing automobiles or computers. Yet, when it comes to keeping valuations equipped with the features and performance required in today's ESOP environment, many trustees are driving outdated, underperforming vehicles that are flat-out unsafe to transport ESOP participants. Change for the sake of fashion is not the point, but some effort to comprehend the standard of quality and performance in the marketplace is required for a trustee to comprehend the relative safety and effectiveness of the appraisal reports being relied on.

Is the Relative Illiquidity (By Way of a Marketability Discount) of a Minority ESOP Appropriate? Is the Use or Lack of Use of Discounts Satisfactorily Explained?

Trustees must demand properly supported discount adjustments and must be keenly aware of any change in such discounts from period to period. Valuations of minority interest ownerships held by an ESOP frequently include a modest discount (say 5%-10%) for lack of marketability.

The primary mitigating factor of a more or less typical marketability discount (say 30%-40%) is the "put provision" enjoyed by ESOP participants. [Note: A given marketability discount is a matter of facts and circumstances specific to a subject ownership interest. The existence of a typical range discounts is somewhat dubious. The cited range is for perspective only.] Sponsor companies are required to provide ESOP participants with a measure of liquidity not otherwise available to most minority interest shareholders. However, this regulatory requirement of the plan does not alone mitigate the marketability discount. Without sufficient liquidity or borrowing capacity, a sponsor company can fall short of financial resources which, in turn, can threaten the liquidity of plan participants. Thus, emerging liability studies, as discussed previously, are not only an important tool for planning but can also be a potentially significant part of an appraiser's ability to determine an appropriate marketability discount.

ESOP companies with poor financial performance, weak future prospects and declining employee headcounts (among other signs) are frequently subject to higher marketability discounts than otherwise healthy sponsor companies. In technical terms, this condition represents the double-whammy where a decline in fundamental enterprise value is compounded by an increase in the marketability discount. Bad things can and do happen in business; however, appraisers cannot fail to recognize impaired liability in the valuation just because of the put provision. In the face of rising liquidity concerns, trustees should be familiar with the analytical tools increasingly employed by appraisers to assess the magnitude of marketability discounts. The lack of sufficiently considering this critical valuation adjustment is of rising concern.

Does the Valuation Reflect an Adjustment to Capture the So-Called "ESOP Benefit"?

Careful scrutiny must be given to potentially controversial adjustments that lead to over-valuation. Such adjustments can lead to valuations that will never reconcile to the market, making a sale of the company unachievable in the context of financial fairness.

For example, in some cases an appraiser may apply an adjustment to eliminate the ESOP contribution expense and then replace it with an otherwise more typical retirement benefit expense. This adjustment reflects the reality that a retirement expense equal to 20% or 25% of compensation is excessive from the perspective of fair market value and that a controlling interest investor in the stock would reduce such expense in order to maximize post-transaction profitability. This adjustment is rational and appropriately factors in the financial profile of a hypothetical investor. However, after analytically doing away with the ESOP for valuation purposes, it is not uncommon for appraisers to then add value related to tax benefits associated with the income tax deductibility of retiring debt principal with pre-tax earnings. While this may be common practice – is it reasonable and is it analytically consistent with the normalizing adjustment for retirement expense?

The merits of valuation adjustments are beyond the scope of this article. However, all adjustments must be examined, particularly if the real marketplace for the subject interest assigns no specific value for such attributes. Such valuation treatments may be tantamount to the standard of investment value rather than that of fair market value. Adjustments which result in over-valuation today can complicate the assessment of the fairness of a real world offer to buy/sell the company in the future. Again, specific adjustments and standards of value are beyond the scope of this article. However, trustees must exercise extreme caution when reviewing valuations with ESOP-specific valuation adjustments. As with all adjustments, definitive support lies in the ability of the hypothetical investor (buyer and/or seller) to reasonably achieve consideration for the item.

Were Excess Premiums Applied in the Valuation of an ESOP with a Controlling Interest?

These adjustments can be tantamount to writing checks that the company simply cannot cash. Over-valuation can plague an ESOP sponsor company and have serious ramifications for participants and selling shareholders.

There are numerous direct and indirect sources for control premium data. The most noteworthy and frequently quoted is *Mergerstat Revie*w which is published annually. This data generally reflects transactions involving large publicly traded enterprises. Perhaps the most frequent culprit in over-valuation is the blind application of Mergerstat-like control premiums in valuations of small private businesses. Compounding this error is the simultaneous application of controlling interest style adjustments (such as earnings enhancements, asset write-ups). With multiple elements of the valuation overstated, is it any wonder that the mathematical product of these components is frequently overstated? Published control premium data frequently reflects synergistic motivations that go beyond financial considerations and reflect other than cash equivalent currency as the medium of exchange.

Additionally, adjustments for compensation, related party expenses and other discretionary items are generally part of a controlling interest valuation. Should these savings not come to pass then such adjustments are the equivalent of an excess control premium. It is important for trustees to identify all valuation treatments that directly and indirectly constitute a control premium and to ascertain if any doubling counting has occurred.

Parting Thoughts

Ascertaining whether or not an ESOP appraisal is reasonable can be difficult. Trustees may argue - that is the reason an appraiser is hired in the first place. In today's world of financial reporting, it is the responsibility of CFOs to attest to their company's financial statements and auditors universally qualify that the statements are the responsibility of management. Similarly, the ESOP valuation is the responsibility of the trustee. Often valuation problems begin upon plan installation and are compounded with the passage of time and with annual plan year valuations. There is no simple guide to changing appraisers or addressing shortcomings in the valuation. In fact, the Department of Labor preaches the concept of value in/value out which some trustees may use to justify not changing appraisers or not questioning valuation treatments once a legacy has been established. In the valuation community, we have always reserved the right to improve in our disciplines and to update our thinking as the market evolves and analytical approaches are refined. So too must trustees continue to question and review their appraisals.

Transitioning to another appraiser can be tricky and subject to scrutiny. Was the trustee shopping the value? Did a change occur just prior to a significant transaction? Did a new appraiser discontinue certain valuation methods in favor of other methods? Change, it seems, to a new appraiser is rife with negative connotations. Just as appraisers are required to document their opinions, trustees must follow consistent disciplines when engaging an appraiser, reviewing an appraiser's draft work product, documenting areas of concern and pursuing advisory services (i.e. ERISA counsel, plan administration, etc.) As with all matters related to the oversight of an ESOP, trustees must avail the services of legal counsel to guide them through the process of change as circumstances are often unique.

This brief chapter cannot possibly provide a complete inventory of items and issues that may be important to assessing the health of an ESOP or the prudence of its sponsor company and fiduciaries. If your responses to some of the above questions and scenarios have you concerned or curious, take action to prevent or correct potential problems.

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VALUATION REQUIREMENTS & FIDUCIARY RESPONSIBILITIES OF TRUSTEES

The responsibilities and duties of trustees for qualified employee benefit plans (ESOPs, profit-sharing plans, 401(k)s, etc.), that invest in employer securities are becoming increasingly important. In light of more complex ESOP matters, (i.e. mergers and acquisitions of ESOP companies, plan terminations and amendments, maturing plans and the resulting repurchase obligation, and increasing shareholder litigation), Trustees need to clearly understand their responsibilities and liabilities. Recognition of this fact is leading to the use of a variety of financial advisors, including Trustees, who are independent to the plan, and have the expertise and knowledge base required to engage in complex transactions.

ERISA and the DOL Proposed Regulations

With respect to the purchase and allocation of employer securities as well as the proper maintenance and administration of the plan are set forth in the Employee Retirement Income Security Act of 1974 (ERISA). Actions of Trustees of Employee Stock Ownership Plans are also subject to review by the Department of Labor (DOL); therefore, these duties should also be considered in light of the Proposed Regulations Relating to the Definition of Adequate Consideration (Federal Register 29 CFR Part 2510, May 17, 1988) when stock transactions occur. While these regulations are still outstanding in their proposed form, most ESOP Trustees, counsel and valuation practitioners still look to these regulations for guidance in determining the value of employer securities.

Fiduciary Responsibilities

Actions with respect to a plan by its Trustee(s) under ERISA, must be discharged solely in the interest of the participant and beneficiaries: 1) for the purpose of providing benefits to participants and their beneficiaries; 2) with the care, skill, prudence and diligence under the circumstances that a prudent person acting in the same capacity with such matters would use under similar circumstances; and, 3) in accordance with the document governing the plan insofar as the documents are consistent with ERISA. In addition, the Trustee must avoid either direct or indirect transactions between the Trustee and another party in interest to the plan.

Fiduciary Good Faith Regarding Valuation

The DOL recognizes that ERISA regulations are broad, and allows the fiduciary some degree of latitude as long as transactions are conducted in good faith. A fiduciary is generally considered to have acted in good faith if the valuation of employer securities is arrived at subject to a thorough examination of all the relevant factors to the transaction, or if the fiduciary relies on a valuation of the employer security by an appraiser independent of all the parties to the transaction.

Mercer Capital understands ESOPs because we ourselves are an ESOP company. We provide annual appraisals for ESOP trustees as well as fairness opinions and other valuation-related services for ESOP companies and financial institutions.

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In other words, the scope of the Trustee's responsibility would require that a plan fiduciary either be an expert in stock appraisals, or exercise sound judgment in the selection and assessment of the qualifications of an independent appraiser. Since it is neither practical, nor likely, that most plan Trustees will be thoroughly familiar with business appraisal, the key element of the valuation process from the Trustee's standpoint is to be confident the appraisal firm selected to perform the valuation is well qualified and independent. Qualifications can be based upon a variety of factors including independence, academic and professional credentials, involvement in professional organizations, and related ESOP appraisal experience

Consequences for Breach of Fiduciary Responsibilities

Section 409(a) of ERISA stipulates that a fiduciary who has breached fiduciary obligations be personally liable to make good plan losses which result from the breach, restore plan profits which have been made through the use of assets of the plan by the fiduciary, and be subject to any remedial relief the court deems appropriate. Case studies indicate that the liability for breach of fiduciary duty has usually been limited to restitution (although in egregious cases penalties have been more severe), and provided the courts can determine the Trustee acted in good faith, the Trustee is not obligated to guarantee the outcome of its decisions. The potential for greater monetary penalties may increase the risk factors for all involved. The selection of a qualified appraiser whose appraisal can withstand rigorous scrutiny will assist in minimizing the potential penalties and personal liabilities of plan Trustees.

Conclusion

Mercer Capital is one of the largest ESOP appraisers and one of the largest independent valuation firms in the nation. We have worked with clients in over 500 industry categories and provided independent valuation services for many personal and corporate purposes, including employee benefit plans. Give us a call if you have any questions or if we can help you in any way.

Reprinted from Mercer Capital's ESOP Valuation Advisor, Vol. 9, No. 1, 2000.

ESOP APPRAISAL FOR A CYCLICAL BUSINESS

The Employee Stock Ownership (ESOP) appraisal utilizes the same tools and techniques of any fair market value appraisal assignment, but with an added emphasis on analyst expertise in understanding the market, the economy, and the underlying business model for the subject company. The ESOP appraisal has the added sensitivity of the Plan participants and trustees who don't like to see the value of allocated shares reflect a decline on the annual plan account statements, especially if it's at redemption time.

We all recognize that in the real world, stocks frequently do decline in value, and closely held ESOP shares should be no exception. However, the appraiser of ESOP shares is in a unique position to interpret market, industry, and company performance in the context of a fair market value appraisal. This analysis is even more important for a cyclical company, where sales and earnings declines are expected but seldom forecast. As appraisers, we frequently utilize the tool of average or weighted average earnings in context with a specific company risk premium and earnings growth rate to develop a capitalization rate, or multiple of ongoing earnings. For an annual ESOP appraisal update, the use of average or weighted average earnings can work against the reality of the situation, and it is here that the analyst must have a firm grasp on the underlying trajectory of earnings as the subject company navigates through the down cycle, in anticipation of the expected, but unknown, upside.

Consider the case of Cyclical Growth Company, Inc., ("CGC or the "Company"), a large manufacturer of industrial products, subject to normal business cycle fluctuations. The eight year summary of operations shown in Figure One reflects the peak of the last cycle and the recovery to date in 2006.

During the period 1999 – 2001, earnings are advancing but not at an accelerating rate, and appear in line with management's expectation of a long term growth rate approximating 5%. With the benefit of hindsight, we know that 2001 was the peak of the cycle, we just don't know that for the 2001 appraisal.

Accordingly, a reasonable derivation of the capitalization factor by means of the Adjusted Capital Asset Pricing Model during this time period may include using a 3% specific company risk premium and a 5% sustainable growth rate in earning power. As shown in Figure Two, this results in a multiple of earnings at 7.90x for 2001, applicable to ongoing earnings power.

When applied to the ongoing earning power of CGC, based on 5-year average earnings, a value of $21.75 per share is indicated. Again, this was the peak of the cycle, we just don't know that yet.

By 2002, it is evident that this is the first year of the downturn. As shown in Figure One, earnings approximate one-third of prior levels and sales are down substantially. The Company is able to maintain about the same gross margin as in the prior year, but the cut in SG&A expenses is not enough to avoid an operating margin at about half of the peak (2001) year, although profitability is maintained. Specific company risk has not changed, although interest

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CYCLICAL GROWTH COMPANY, INC. :: Historical Income Statements								
	For the Fiscal Years Ended October 31							
Income Statements	**2006**	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**	**1999**
Net Sales	40,000,000	38,000,000	28,000,000	22,000,000	24,000,000	34,000,000	29,000,000	28,000,000
Cost of Sales	22,000,000	22,000,000	19,000,000	14,000,000	14,000,000	20,000,000	18,000,000	17,000,000
Gross Profit	18,000,000	16,000,000	9,000,000	8,000,000	10,000,000	14,000,000	11,000,000	11,000,000
Operating Expenses	11,000,000	10,000,000	8,000,000	7,000,000	8,000,000	8,000,000	6,800,000	7,000,000
Operating Income/(Loss)	7,000,000	6,000,000	1,000,000	1,000,000	2,000,000	6,000,000	4,200,000	4,000,000
Other Income/-Expense								
Interest Income	125,000	125,000	125,000	125,000	125,000	125,000	125,000	125,000
Interest Expense (-)	(325,000)	(325,000)	(325,000)	(325,000)	(325,000)	(325,000)	(325,000)	(325,000)
Other, Net	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000
Total Other Income/-Expense	0	0	0	0	0	0	0	0
Pre-Tax Income/(Loss)	7,000,000	6,000,000	1,000,000	1,000,000	2,000,000	6,000,000	4,200,000	4,000,000
Income Tax Expense/-Benefit	(2,660,000)	(2,280,000)	(380,000)	(380,000)	(760,000)	(2,280,000)	(1,596,000)	(1,520,000)
NET INCOME / (LOSS)	$4,340,000	$3,720,000	$620,000	$620,000	$1,240,000	$3,720,000	$2,604,000	$2,480,000
Analytical Ongoing Earning Power	$2,893,333	$1,984,000	$1,760,800	$2,132,800	2,504,800	2,752,800	2,529,600	$2,294,000
	(3-Year Avg.)	*(5-Year Avg.)*	*(5-Year Avg.)*	*(5-Year Avg.)*	*(5-Year Avg.)*	*(5-Year Avg.)*	*(5-Year Avg.)*	*(5-Year Avg.)*
Gross Margin	45.0%	42.1%	32.1%	36.4%	41.7%	41.2%	37.9%	39.3%
Operating Margin	17.5%	15.8%	3.6%	4.5%	8.3%	17.6%	14.5%	14.3%

FIGURE ONE

rates are now lower in the recession. Since the length and depth of the downturn are unknown, and the average earnings analysis has produced ongoing earnings of $2.5 million (versus reported earnings of $1.2 million), it may still be reasonable to expect a long term growth rate of earnings at 5%, resulting in only a modest decline in value compared to 2001.

By 2003, it is clear that the recession and decline in sales and earnings are for real. Reported earnings are now about half of 2002 and approximate about 16% of the peak (2001) year, although still profitable. The length and depth of the recession are still unknown, but recent history tells us that recessions are shorter than expansionary phases. The 5-year average earnings analysis still provides some moderation to ongoing earnings (now assuming a reasonable recovery). With the specific company risk premium unchanged, and given the underlying growth rate of earnings approximating 5%, it may now be feasible to assume that with earnings acceleration upon the recovery, the long term growth rate of earnings for the determination of a single-point capitalization rate may be 7%. This results in a higher multiple on lower earnings, which is exactly what the market would typically do if the Company were publicly traded.

By 2004, the sales decline has now ended, but profitability has not fully recovered, as the Company has maintained sales with lower margin products, and boosted SG&A expenses back to the 2002 – 2001 level. The operating margin at 3.6% is the lowest in the last six years, and earnings at $620,000 matches 2003's performance, Management may have a feel for a prospective, but undefined recovery at this point, but we will not know that this is the nadir of the cycle until we can look back on it. Given the relatively low ongoing earnings based on the 5-year average earnings analysis, in context with a prospective, but undefined recovery, it may be reasonable to boost the growth rate of earnings to 8% for 2004, anticipating a recovery by 2005.

By 2006, the recovery is clearly in place, with sales and earnings greater than expected. The gross margin has improved to its highest level, exceeding the peak in 2002 – 2001. Operating expenses have increased too, with additional catch-up bonuses to employees who sought to maintain market share in the recession. The operating margin now approximates the peak in 2001. Earnings are at the highest level ever, at $4.3 million. With the Company clearly beyond the recession, it may be time to modify the average earnings analysis to a 3-year average, which picks up the two recovery years, but tempers that with the

DIRECT CAPITALIZATION OF EARNINGS METHOD (using ACAPM) Multi-Year Summary								
Derivation of Capitalization Factor	**2006**	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**	**1999**
Long-Term Gov't Bond Yield-to-Maturity	4.81%	4.61%	4.85%	5.10%	4.83%	5.74%	5.59%	6.83%
Ibbotson Common Stock Premium								
x Market Beta								
= Beta Adjusted Common Stock Premium								
+ Small Capitalization Stock Premium								
= Total Equity Premium	8.90%	8.90%	8.90%	8.90%	8.90%	8.90%	8.90%	8.90%
+ Company Risk Premium	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
= Discount Rate (Required Rate of Return)	16.71%	16.51%	16.75%	17.00%	16.73%	17.64%	17.49%	18.73%
- Sustainable Growth Rate in Earning Power	-5.00%	-8.00%	-8.00%	-7.00%	-5.00%	-5.00%	-5.00%	-5.00%
= Minority Interest Capitalization Rate (CR)	11.71%	8.51%	8.75%	10.00%	11.73%	12.64%	12.49%	13.73%
Minority Interest Capitalization Factor (1/CR, or P/E Ratio)	8.54	11.75	11.43	10.00	8.53	7.91	8.01	7.28
ACAPM Capitalization Factor (round to 0.05)	**8.55**	**11.75**	**11.45**	**10.00**	**8.55**	**7.90**	**8.00**	**7.30**
Derivation of Value	**2006**	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**	**1999**
Ongoing Earning Power	$2,893,333	$1,984,000	$1,760,800	$2,132,800	2,504,800	2,752,800	2,529,600	$2,294,000
x ACAPM Capitalization Factor	8.55	11.75	11.45	10.00	8.55	7.90	8.00	7.30
= Capitalized Earnings Value	$24,738,000	$23,312,000	$20,161,160	$21,328,000	$21,416,040	$21,747,120	$20,236,800	$16,746,200
Shares Outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Value Per Share	**$24.74**	**$23.31**	**$20.16**	**$21.33**	**$21.42**	**$21.75**	**$20.24**	**$16.75**

FIGURE TWO

last diminutive year of the recession. From this recovery earnings level, the earnings growth rate as a component of the capitalization rate is no longer 8%, but can reasonably be expected to achieve the 5% projected by management.

During the economic cycle described, the Company has experienced significant changes in financial performance. While consistency is important in an ESOP appraisal, the analyst need not be crucified on the cross of consistency. Given the modest changes in interest rates, and a constant specific company risk premium, the key variables here involve the growth rate of earnings and the average earnings base (ongoing earnings) to which the capitalization multiple is applied. It is at this decisive analytical juncture that the seasoned analyst has an edge: experience counts. Experience with the variance of market cycles and the nature of equipment manufacturers during different phases of the economic cycle, in context with the legacy experience in the analysis of the Company and its management all comes together to provide an analytical perspective allowing the adjustment (and defense!) of key benchmarks in the multiple and the ongoing earnings to which it is applied. A summary of the capitalization of earnings approach since the peak in 2001 is shown in Figure Two.

In the case of Cyclical Growth Company, Inc., the analysis has reflected the reality of the marketplace at key junctures in the economic cycle. While the future is uncertain during the freefall part of the cycle, the averaging of earnings provides some moderation to the decline (assuming, of course, that earnings actually will recover). Moderating the growth rate at the proper time, based on experience, assigns a higher multiple to lower earnings, which is exactly what the public market does. Finally, with the recovery in place, a re-adjustment of the growth rate of earnings and the averaging process results in a reasonable assessment of the future at the valuation date. From the ESOP participant's point of view, the per share value declined only modestly over three years, but not nearly as severely as the decline in earnings for those years, and the value upon recovery exceeds the prior peak in 2001.

If you need the experience of a seasoned analytical team to define and defend the appraisal of your ESOP, or for other business valuation resources, please give us a call at Mercer Capital to discuss your specific requirements in confidence.

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RECONCILING CHANGES IN VALUE

Mercer Capital performs scores of annual appraisals for Employee Stock Ownership Plans ("ESOPs") across the country. We have reported significant valuation fluctuations in many of our ESOP companies given the economic and geopolitical environments of certain years. The dramatic declines in business activity that accompany recessions cause many private company stock valuations to decline. While the analytical disciplines employed by appraisers are becoming more refined, the experience and execution among appraisers is arguably less consistent than ever. Regardless, an ESOP Trustee must understand the fundamental and technical reasons underlying year-to-year changes in the company's stock value.

A properly documented appraisal report should provide a clear explanation for changes in value. A reconciliation of the current opinion to previous opinions is a critical part of empowering the Trustee and other representatives with an understanding of the valuation process.

A functional and concise reconciliation of value should highlight the primary variable(s) that have an impact on the valuation. A well-articulated report will clearly identify the methods employed to value the stock and the primary variables underlying the various approaches utilized. It helps to start with the big picture first, distilling information down to the functional, contributory elements of each major area of consideration. While a given valuation opinion can be asset-based or earnings-based (or some combination), Mercer Capital has long represented the fundamental formula of value as:

Value = Earnings x Multiple

"Earnings," as adjusted for unusual or nonrecurring items, are generally the result of executing the business plan. However, it is up to the appraiser to determine the appropriate "multiple."

The multiple results from synthesizing empirical market data concerning rates of return with specific assessments of the subject company's risk and growth profile. From year to year a company's earnings performance can obviously change with such change being a factor beyond the appraiser's control. So while the "E" or earnings are up to the company, the "M" or multiple, is ultimately why the Trustee retains an appraiser whose task it is to determine the valuation multiple from market data and from the evolving risk profile and growth opportunities of the business.

While judgmental to some degree, assumptions concerning risk and growth should be traceable to tangible observations of specific business and/or environmental fundamentals. Appraisers are charged with the responsibility of developing opinions using reason, informed judgment and common sense. While differences of opinion can exist concerning valuation changes, a clear explanation of circumstances, as considered by the appraiser, is necessary for the Trustee to review and critique the opinion in the draft review stage.

Functionally, the four primary methods used to value the stock of a company include: 1) Cost Method – a balance sheet concept driven by net asset value mechanics; 2) Income Method – effectively the present value of the ongoing income stream or cash flows of the business; 3) Market Method – direct observations of transactions involving similar ownership interests; and 4) Guideline Company Method – using peer public company valuation

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metrics. Each of these methods may involve sub-methods or approaches based on the appraiser's assessment of those methods appropriate for the business. The key to a comprehensive reconciliation of value is the detailing of the driving elements of these methods and how they are synthesized into a conclusion of value. In addition to the core methodology of the valuation are certain adjustments that generally encompass valuation premiums and/or discounts.

With the previous conceptual overview as a foundation, the table below is a summary inventory of elements underlying most valuations. The list is not all-inclusive. It begins with the conclusion of value and digresses to the primary drivers of most valuations. Observing changes in these drivers (and understanding any interactions among them) should provide a Trustee with an understanding of what happened in the valuation and, perhaps more importantly, why.

A reconciliation of value provides an effective basis of reviewing a newly updated plan year valuation. Mapping the basics of the valuation from beginning to end and examining the changes in the primary elements of value empowers a Trustee to understand and critique the valuation. While a reconciliation of value is not expressly required under valuation standards, its absence may contribute to less than thorough consideration by the appraiser. Given an elevation in concern about the valuation trends of an ESOP over time, the above outline is effective for the forensic study of historical valuations.

If you have an ESOP-related valuation question or concern, please do not hesitate to contact us for a confidential assessment of your ESOP valuation.

Reprinted from Mercer Capital's ESOP Valuation Advisor, Volume 13, No 2, 2004.

Valuation Component	Observation/Question
Value Per Share	*Did the share counts change?*
Shares Outstanding	*Have dilutive items and features changed?*
Stock Options & Other Dilutive Items	
Concluded Value of Business	
Discounts Applied	*What happened to the magnitude of any discounts? Why?*
Premiums Applied	*What happened to the magnitude of any premiums? Why?*
Weighted Average Indication of Overall Value from Methods:	*Typically, a valuation reflects an avg. of more than one method or approach*
Weights Applied to Various Methods	
New Methods Used	*What circumstances support using new methods?*
Old Methods Abandoned	*What circumstances support discontinuing a method?*
Changes in Weights Applied to Various Methods/Approaches	*What is the rationale for altering weights over time?*
Guideline Method:	*Is there sufficient comparability to public companies?*
New Approaches Used	*What circumstances support using new approaches?*
Old Approaches Abandoned	*What circumstances support discontinuing an approach?*
Changes in Cash Flow & Earnings Adjustments	*What happened and what is expected going forward?*
Changes in Public Market Valuation and Performance	*What is happening to the public sector, will it translate?*
Changes in Fundamental Adjustment to Public Data	*Is the Company more or less comparable to its peers? Why?*
Changes in Public Company Population Used	*Is there industry shake-out? Has the screening criterion changed?*
Income Method:	*Conceptual framework ≈ Value = Earnings x Multiple*
Changes in Cash Flow & Earnings Adjustments	*What happened and what is expected going forward?*
Changes in Company Risk Profile ("M")	*Changes in concentrations on products, suppliers, executives, etc.?*
Changes in Company Growth Opportunities ("M")	*Changes in future prospects for growth? Margin, Volume, other?*
Changes in Broad Market Rates of Return & Interest Rates	*Did bonds yields and equity premiums change? Impact on value?*
Transaction Method:	
Change in Trends of Arms' Length Action of Similar Interests	*Have similar interests transacted? How do such events translate?*
Cost Method - Market Value Balance Sheet	
Changes in Values for Underlying Assets	*Have key assets increased or decreased in value?*
Changes in Financial Composition & Leverage	*Has the Company leveraged up? Impact on net worth?*
Impact of Operations on Balance Sheet Standing	*How have operating activities and results affected the balance sheet?*

CHANGING ESOP APPRAISERS: WHY IT MIGHT BE NECESSARY

ESOP valuation is an increasing concern for Trustees and sponsor companies as many ESOPs have matured financially (ESOP debt retired and shares allocated), demographically (aging participants), and strategically (achieved 100% ownership of the stock).

Given these and other evolving complexities (including the proposed DOL regulation which would designate ESOP appraisers as fiduciaries of the plans they value), it is sometimes necessary or advisable for ESOP Trustees and the Boards of ESOP companies to change their business valuation advisor.

This article addresses why a Trustee or sponsoring company might or should opt for a new appraisal provider, as well as what criteria, questions, and qualities drive the process of selecting a new appraiser.

There are potentially many circumstances and/or motivations that can compel an ESOP Trustee to seek a new valuation advisor.

- **The current appraiser is no longer available or is unwilling to perform the annual plan year valuation.** Due to retirement, firm closure, conflict of interest, or some other reason that is beyond the control of the Trustee or sponsor-company board, the legacy appraiser is not available or willing to perform annual plan year valuations.
- **The legacy appraiser has resigned from the ESOP appraisal due to evolving regulatory decisions from the DOL.** As of the drafting of this article, the DOL has requested and considered feedback and testimony concerning the designation of ESOP appraisers as fiduciaries of those plans they value. Collectively, the ESOP appraisal community has responded in opposition. A number of ESOP valuation firms have identified this issue as a potential "make or break" concerning the continuation of ESOP appraisal services. As such, if the proposed regulations are enacted, growing numbers of sponsoring companies may be forced to identify and retain a new appraiser because their legacy appraiser has resigned from the ESOP appraisal. This issue and its ramifications for Trustees, sponsoring companies, and ESOP appraisers warrant continued monitoring.
- **Growth and/or evolution in the sponsor company's business model, industry, market complexity, management, or otherwise** can take a business from a once comfortable and familiar place for the appraiser to one that is beyond their resources and competencies.
- **The maturation of the ESOP may be creating new or increased concerns regarding the valuation** or other Trustee considerations that are not being adequately addressed or integrated into the valuation or into other financial advisory feedback and support often provided by valuation experts.
- **The legacy appraisal product does not reflect current valuation theory, methodology, and/or reporting standards.** Trustees that suspect their valuations are lacking in thoroughness, accuracy, or

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reasonableness might be well-served to obtain an independent review of the work to identify problem or missing content before any decision is made to change appraisers.

» **The sponsor company has experienced volatile or declining performance that is not quantified or otherwise addressed in the ESOP valuation.** There has been much written by valuation practitioners concerning the relative volatility of closely held valuations to the valuations of the broader (public) market place. The lack of reconciling valuation information and conclusions to market and/or financial evidence may suggest a variety of ills ranging from complacency to advocacy.

» **The appraisal conclusions and underlying valuation components have not been reconciled with prior valuations or over time.** Trustees need to be able to examine the underlying performance, market evidence, and valuation treatments over time in order to offer constructive feedback and questions, as well as to track the investment and operating performance of the sponsor company. However, keep in mind that valuation practitioners must be allowed to enhance or augment their reports and methodology with the passage of time, the advancement of analytical treatments and approaches, the evolution of the body of knowledge, in response to draft review processes, and to comply with changes in regulations and compliance requirements.

» **Excess control premiums have been applied to a controlling interest ESOP valuation** resulting in a potentially higher than reasonable value and causing serious ramifications for participants and sponsor companies. Over-valuation is a consistent issue in many ESOP appraisals. A principal cause of over-valuation is the direct or implicit application of unwarranted or unsupportable control premiums.

Control premiums, particularly when styled as specific and finite adjustments in a valuation, are generally not advisable in the appraisal world unless they are explained and reconciled financially. If the appraiser cannot articulate the financial basis for the application of (and the magnitude of) a control premium by direct reference to earnings enhancements, risk mitigation, enhanced growth rates, or other fundamental valuation drivers and assumptions, then a Trustee would be well-served to question the appropriateness of the premium.

Excess control premiums may exist below the surface in a valuation in the form of unsupportable adjustments to earnings and cash, aggressive capital structure assumptions, excessive growth rates, improper or unsupported weighting of valuation methods, unsupportable averaging of past performance that is unlikely to return in the foreseeable future, low rates of return, inflated financial projections, or numerous other treatments.

Some appraisals may subtly (or unintentionally) rely on the upper end of the range of valuation assumptions, thereby compounding a series of seemingly reasonable control treatments or adjustments into an unsupportable valuation conclusion.

» **Over-valuation can also result from a failure to reasonably modify or abandon control-style treatments over time** due to changes in market evidence, economic/financial cycles, or changes in company performance and/or outlook. Has the company's management and/or non-ESOP shareholders lived up to their end of the bargain by modifying their compensation to comply with valuation treatments applied to develop transaction pricing? If not, how has the appraisal treated the issue?

» **Valuation discounts are insufficient or missing, resulting in valuation conclusions that do not comply with the level of value defined by the Trustee.** Many minority interest ESOPs are effectively valued on a quasi-control basis. Is this reasonable or proper? Is the marketability discount appropriate in light of the sponsor company's financial health and the needs of plan participants?

» **The aging of baby boom participant pools** requires that the demographics of plan participants be examined for diversification or retirement needs.

» **Repurchase obligation is a seminal issue in ESOP valuation.** Appraisers should inquire about projected retirement needs of both ESOP participants and other shareholders or significant managers. Repurchase obligation studies are the order of the day for Trustees and sponsor company boards. In some cases, non ESOP shareholders requiring accommodation via stock redemption may have needs or expectations that conflict with needs arising from an accumulation of ESOP participants awaiting contributions and/or distributions for retirement or diversification purposes.

» **A change in the ESOP Trustee** may bring about a change in the appraiser.

» **The ESOP valuation fails to reconcile to non-ESOP appraisals or other appraisals used for capital raising or other purposes.** There are reasons why this could or should be the case. However, significant valuation events that fail to reconcile to the ESOP valuation can suggest serious issues.

» **A lower professional fee is needed or, perhaps, the conclusion of value is not desirable.** Fee sensitivity is arguably a good trait for ESOP Trustees, as long as valuation quality is not compromised. However, shopping the valuation for a targeted treatment or result is a dangerous endeavor.

» **There are service and timeliness issues with the current appraiser.** The need for expediency cannot compromise accuracy or completeness in the valuation. The timing and responsiveness of information production is the key to a good appraisal experience.

» **The ESOP is terminating.** Termination events often involve fairness opinions and other advanced considerations, prompting a change in the appraiser or the use of a secondary appraiser to advise the Trustee in a consultancy role. The same may be true for secondary and/or consolidating ESOP transactions.

Conclusion

There are risks involved when making the decision to select a new appraiser, including a change in valuation methodology, a possible meaningful change in share value, and the perceived independence of the Trustee (and appraiser) from the perspective of regulators and/or plan participants. Some Trustees are simply averse to the potential backlash or complications that can arise from changing appraisers. However, in many situations, a change is needed and prudent and a lack of change can be viewed as creating or worsening a valuation issue.

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THE PROCESS OF SELECTING A NEW ESOP APPRAISER

When the decision has been made to select a new qualified appraiser, it is appropriate for the Trustee to begin an orderly process of interviewing more than one potential valuation expert in order to make an informed decision.

Therefore, Trustees and/or sponsoring companies should consider the following:

» **Industry Expertise or Valuation Expertise?** Although "industry experts" in a variety of industries are abundant, it is generally advisable to prioritize valuation expertise over industry expertise in the ESOP world. Industry experts, although knowledgeable about their particular industry, frequently lack even a basic understanding of the concept of fair market value as it pertains to a particular level of value in the context of a private company ESOP. It is advisable to look for appraisers with a working and current knowledge of ESOP valuation issues.

» **Is the appraiser a sole practitioner or the member of a firm with other skilled ESOP appraisers that can readily stand-in if the original practitioner leaves the firm, retires, or exits the field?** The involvement of multiple professionals (often contributing to or administering to varying elements of the valuation process) working collectively under the supervision or a senior-level practitioner may provide the back-up that mitigates the potential disruption caused by the departure or unavailability of the legacy/primary appraiser.

» **The ESOP appraisal experience of the business valuation firm**, including the number of ESOP valuations performed over the history of the firm, as well as the current number of ESOP appraisals performed.

» **Non-ESOP appraisal experience of the business valuation firm.** Some ESOP stakeholders might consider a firm that only specializes in ESOP appraisals an advantage. Others could perceive such a service concentration as inherently risky or too professionally confining for the appraiser to gain collateral professional financial services experience.

» **The professional credentials held by the business appraisers within the firm being considered.** Professional valuation credentials generally include the following: Accredited Senior Appraiser (ASA), Accredited in Business Valuation (ABV), Certified Business Appraiser (CBA), Certified Valuation Analyst (CVA), and Chartered Financial Analyst (CFA). To date, government agencies do not certify appraisers in the discipline of business valuation. Accordingly, professional credentials and valuation experience are critical considerations in vetting a new appraisal firm.

» **Affiliation with the ESOP Association and/or the National Center for Employee Ownership**; articles published; speeches given; conferences attended.

» **The valuation methods typically employed** and the relative weight applied to each.

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- Has a regulatory challenge ever been leveled against the proposed ESOP appraiser?
- The appraiser's position regarding:
  - An ownership control price premium applied to an ESOP's purchase of the employer corporation stock and, conversely, a minority interest discount applied to an ESOP's purchase of employer corporation stock.
  - A marketability discount in view of the ESOP participants' put option rights.
  - The typical range of the marketability discount applicable to ESOP-owned employer stock.
  - The appraiser's treatment and/or consideration of the ESOP's repurchase obligation.
- The appraiser's experience as an expert witness in litigation or plan audit matters involving the IRS, the DOL, or ESOP participants and the outcomes of such events. It could well be that an experienced ESOP appraiser with limited or no litigation experience is preferable to one that has repeatedly been required to defend their appraisals in audit and litigation proceedings.
- Estimates of professional fees (both current and on-going).
- The appraisal firm's valuation process, including an understanding of the timing to complete the valuation engagement.
- The extent to which the financial advisor expects to work interactively with sponsoring company management during the valuation process.

The Trustee has a role to play in providing pertinent information to the prospective appraisal firms such that they can understand the proposed project and provide a comprehensive proposal of services. As such, the Trustee should provide the following information to the appraiser candidates:

- Historical financial statements (typically 5 years)
- Previous ESOP valuation reports
- History of the subject plan
- Information on the ESOP sponsor company

The Trustee's selection decision should be based on the overall qualifications of the business appraisal firm. Discussion of the probable valuation outcome during the selection phase could be misleading or taint the process. In cases where a new appraiser serves as a review resource to the Trustee, there could be situations when differences of treatments and methodologies are discussed, as well as the impact that valuation modifications or additions would have on an appraisal issued by the previous appraiser. In such cases, the new appraiser has the burden of independence and credibility and Trustees have the obligation of obtaining the best information and not a predetermined outcome from a change in the appraisal firm. As stated previously, shopping the valuation for a targeted treatment or result is a dangerous endeavor.

The selection process should also be reasonably documented so that the questions of "why was a change necessary?" and "how was the selection process undertaken?" can be answered by the Trustee.

Conclusion

The selection process should serve to ensure that the change in appraisers minimizes or mitigates the negative impact on the ESOP, and the ESOP participants (or that a change is accompanied by necessary, long-term considerations, even if a change in the valuation provider results in a meaningful near-term impact on the ESOP) and should be rigorous enough to withstand scrutiny from government regulators and plan participants.

Given the economic uncertainties in recent years, the continuing globalization of markets, the evolution of valuation science, and the growing concern for DOL compliance, Trustees must retain the right and conviction to source valuations from providers that can properly develop and defend their appraisal results.

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MERCER CAPITAL'S ESOP VALUATION PROCESS

The process of a business valuation can differ from firm to firm, therefore, we thought it helpful to elaborate on Mercer Capital's valuation process.

Introductory Phase

During the initial introduction, we request certain descriptive and financial information (usually recent audits and marketing brochures) to help define the scope of the business in the context of an ESOP appraisal. Defining the project is a critical phase of the valuation, and can be accomplished with telephone and personal visits with the company and its professional advisors, as required.

Engagement Phase

Once the valuation project has been defined, an Engagement Letter is issued setting forth the key elements of the appraisal assignment. Typical elements included in the letter are the name of the client (usually the Trustee of the Plan), the official name of the entity to be appraised, its state of incorporation or organization, its principal business location and the specific business interests to be appraised. Additionally, the letter indicates the appropriate standard of value (fair market value), the premise of value (controlling or nonmarketable minority interest), the effective date of the appraisal, and the type of report to be produced. There are three scopes of work, including appraisals, limited appraisals and calculations as defined by the *Business Valuation Standards* of the American Society of Appraisers.

The Engagement Letter provides a descriptive project overview, outlines the Mercer Capital's qualifications and sets forth the timetable and fee agreement. Included along with the Engagement Letter is a comprehensive checklist request for information. The information requested includes the company's historical financial statements and detailed operating and structural information about the business, and the market in which it operates.

Valuation Phase

Upon execution of the Engagement Letter by the responsible party, including a response to the checklist request for information, we begin our preliminary analysis of the company, including research and review of appropriate industry data and information sources. As securities analysts, we recognize that an appraisal of common stock represents an assessment of the future at a current point in time. Yet, most of the information available to the analyst is historical information. The future will likely change relative to the past, and we know that management will be largely responsible for making that future happen.

Accordingly, upon review of the checklist and industry information, we schedule an on-site appointment with management to discuss the operations of the business. Normally, one or two business valuation professionals will visit with management at the headquarters location to:

» Review in detail the Company's background, financial position, and outlook with appropriate management personnel

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» Review appropriate corporate documents not normally exchanged by mail or email

» Tour the operations

» Respond to questions from management

The Company visit provides an important perspective to the business valuation, since it puts the analyst in direct contact with the individuals responsible for shaping the future performance of the Company. In a very real sense, management's input will shape the investment decisions to be made by the appraiser in reaching a conclusion of value.

Following the Company visit, the analysis is completed, making specific documented adjustments discussed with management, in context with more subjective conclusions involving the weighting of some factors more than others. Prior to sending a draft report, the valuation analysis and report is thoroughly reviewed by other in-house analysts to ensure that the initial conclusions are well- reasoned and supportable.

The client's review of our draft report is an important element in the process. We believe it is necessary to discuss the appraisal in draft form with management and the Trustee of the ESOP to assure factual correctness and to clarify any possible misunderstanding from our company interview.

Upon final review, the valuation report is signed by the major contributing appraiser, and is reproduced in sufficient number for the Plan's distribution or documentation requirements.

The Mercer Capital Difference

Mercer Capital understands employee stock ownership plans because we ourselves are an ESOP company. We provide annual appraisals for ESOP Trustees as well as fairness opinions and other valuation-related services for ESOP companies and financial institutions.

We bring over 30 years of valuation experience to every ESOP engagement. The stability of our staff and our long-standing relationships with clients assure consistency of the valuation methodology and the quality of analysis for which we are known and for which you deserve.

We are active members of The ESOP Association and the National Center for Employee Ownership (NCEO). Each of the senior analytical professionals of Mercer Capital has extensive ESOP valuation experience, providing primary senior-level leadership on multiple ESOP engagements every year.

For more information, contact Tim Lee, Nick Heinz, or Wendy Ingalls at 901.685.2120.

THE 1042 ROLLOVER

RESURRECTED INTEREST IN TAX BENEFITS FOR SELLING SHAREHOLDERS IN ESOP TRANSACTIONS

For many business owners, the investment in their company is their most significant asset. Shareholders of closely held businesses, particularly those on the crest of the baby boom wave, are rigorously searching for exit plans to diversify their portfolios and to plan for the next stage of life. It certainly helps if the exit plan is aligned with a compelling estate and tax strategy. In this era of challenging credit conditions and economic uncertainty, interest in Employee Stock Ownership Plans ("ESOPs") is rising as sellers come to understand the varying opportunities related to transaction financing and to potential tax benefits accorded qualified sellers to ESOPs. One such potential benefit for selling shareholders is the 1042 rollover.

Internal Revenue Code Section 1042 provides beneficial tax treatment on shareholder gains when selling stock to an ESOP. Given certain conditions, capital gains tax can be deferred allowing the full transaction proceeds to be invested in Qualified Replacement Property ("QRP"). Long-term capital gains are recognized upon the liquidation of QRP securities at a future date after a required minimal holding period. If the QRP is not liquidated and becomes an asset of the seller's estate, it enjoys a stepped up basis and avoids capital gains completely.

Summary Requirements

In order for the sale of stock to qualify for a 1042 rollover, several requirements must be met:

1. The seller must have held the stock for at least three years;
2. The ESOP must own at least 30% of the total stock immediately following the sale; and,
3. The seller must reinvest the proceeds into "qualified replacement properties" within a 12 month period after the ESOP transaction.

Qualified replacement property is defined as stocks and bonds of United States operating companies. Government securities do not qualify as replacement properties for ESOPs. The seller must invest in these properties within a 15 month period beginning three months prior to the sale and ending 12 months after the sale. The money that is invested can come from sources other than the sale, as long as that amount does not exceed the proceeds. However, not all of the proceeds have to be reinvested. If the seller chooses to invest less than the sale price, then he or she will have to pay taxes on the amount not invested in QRP. In order to meet the 30% requirement, two or more sellers may combine their sales, provided that the sales are part of a single transaction. The sponsor Company must be a C Corporation for selling the shareholder to qualify for a 1042 rollover.

The shares sold to the ESOP can not be allocated to the ESOP accounts of the seller, the relatives of the seller (except for linear decedents receiving 5% of the stock and who are not treated as more-than-25% shareholder by attribution), or any more-than-25% shareholders.

Mercer Capital understands ESOPs because we ourselves are an ESOP company. We provide annual appraisals for ESOP trustees as well as fairness opinions and other valuation-related services for ESOP companies and financial institutions.

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1042 Rollover Benefits

The current federal capital gains tax is 15%, but if no legislative action is taken, on January 1, 2011, the federal (long-term) capital gains tax will revert to 20%, making the 1042 rollover option more attractive and beneficial to business owners. If an owner with a $2,000,000 basis sells his or her shares for $5,000,000 and realizes a capital gain of $3,000,000, he or she would defer or save $450,000 in capital gains taxes under today's tax structure. Given no legislative action and a 2011 reversion to previous capital gains rates of 20%, a seller would defer or save $600,000 in federal capital gains tax on the sale as shown below.

	2010	2011
Loan for ESOP Purchase	$5,000,000	$5,000,000
Tax Bracket	34%	34%
Tax Savings from P&I Deduction	$1,700,000	$1,700,000
+ Capital Gains Tax Savings	$450,000	$600,000
Total Federal Tax Savings	$2,150,000	$2,300,000
Total Savings / Sell Price	43%	46%

If legislative action is taken that results in an even higher capital gains tax rate, a 1042 rollover becomes even more attractive.

Leveraging the sale of stock to the ESOP can provide further financial benefit to the company and its shareholders. Sellers often use all or part of their replacement property as collateral for loans used to finance ESOP purchases. Financing costs are significantly lower for corporations that borrow to purchase owner's stock for ESOPs than for conventional stock redemption because the corporations are able to deduct the principal and interest payments on the loan when used to purchase ESOP stock. If a corporation is in the 34% tax bracket and borrows $5,000,000 to purchase the ESOP stock, it would save $1,700,000 in federal income taxes. Combined with the $450,000 in savings with the current capital gains tax rate, the federal tax savings would be $2,150,000 or 43% of the selling price. If capital gains tax rates revert to the previous rate of 20%, the total federal tax savings would be $2,300,000 or 46% of the selling price.

S Corporations

Although S Corporations are allowed to have ESOPs, the 1042 rollover option is not available to the shareholders. In most cases, there is a 25% limit on tax-deductible contributions made by employers to ESOPs. C Corporations do not have to count interest payments on ESOP loans as part of the 25% limit, but S Corporations do. There is no required length of time during which a corporation must have C status to receive the benefits of the 1042 rollover, which means that an S Corporation can change its status and receive the differed tax benefits without delay. However, this change in status can have negative tax effects that would cancel out any benefits gained from the 1042 rollover status due to different accounting methods, so a change in status may not always be the best option.

ESOP Financing

Given the corporate development criterion of most strategic and financial buyers in the markets today, relatively few small-to-medium sized business owners can achieve an exit via a transaction with an external buyer. Throw in the difficulties of financing acquisitions and many shareholders of successful and sustainable businesses may be locked out of certain exit strategies. Increasingly, sellers to ESOPs are financing their own transactions. Before the financial crisis struck, many ESOPs sellers found that continuing business involvement and loan guarantees were required by ESOP lenders. The realization: seller financing in today's market represents little incremental risk and time than in previous more favorable markets. True, many valuations may be lower than a few years back, but most good ESOP candidates have likely fared better than the markets as a whole. Absent the need for lump sum liquidity, and given a strong and early start to longer-term exit planning, seller-financed ESOPs may be a viable and preferable path for many closely held business owners.

What Goes Down Must Go Up

Confused? We're alluding to taxes – in the context of a nation whose thirst for government spending had been both red and blue in the past ten years and shows little sign of being quenched. The likely result, relentless tax pressures even if significant belt tightening occurs. For those business owners committed to the long-term success of their businesses, concerned about the fate of their employees, and who have a desire for favorable tax treatment in the course of achieving succession and exit planning, the ESOP is a viable alternative. As taxes went down in previous years, so it seems they are going up. As ESOP formation waned in a previous market where external exit opportunities abound and have now collapsed, ESOP formation appears primed to go up. ESOPs represent one of the few exit plans that can be timed and entered into without a change of control. In an increasingly uncertain world, throw in a healthy dose of tax advantages for qualified sellers and it is hard not to view the ESOP with increased interest.

Mercer Capital has over 25 years of experience providing ESOP valuation services and is employee-owned, giving us a unique perspective. For more information or to discuss a valuation issue in confidence, give us a call at 901.685.2120.

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FAIRNESS OPINIONS IN ESOP TRANSACTIONS

The following question and answer format allows the reader to focus on material of specific interest. Additional must-read materials related to your questions about fairness opinions and other ESOP-oriented topics are available on this website.

Q: Why are fairness opinions important?

Prepared by an independent financial advisor, a fairness opinion is just that – an opinion that a proposed transaction is fair (or not) from a financial point of view, to shareholders of a company (either all or a certain specific group of shareholders). A fairness opinion can assist corporate directors and/or ESOP trustees in making or approving decisions concerning strategic and financial events. A fairness opinion can also instill confidence among stakeholders that an action has been thoroughly vetted for its effects on the ESOP and/or the sponsoring company. These opinions can aid in substantiating that decision makers have adhered to the business judgment rule.

Q: Does a transaction involving or affecting an ESOP require a fairness opinion?

The prudent answer is yes. Despite out belief that transactions affecting or potentially affecting an ESOP should include a fairness opinion, such opinions are rare. Some business owners and trustees believe that fairness opinions are time-consuming, costly, uncommon, unnecessary, or excessive for many transactions. Perhaps, in some circumstances, a fairness opinion could be viewed as nonessential. However, every ESOP installation and every ESOP termination, and virtually every significant corporate (or strategic) event in an ESOP sponsoring company would be better served to include a fairness opinion rendered from the financial perspective of the ESOP and its trustee.

That an ESOP transaction or significant corporate event that affects the shareholders or participants of an ESOP company requires a fairness opinion is not specifically codified. Nonetheless, obtaining the service can be a vital, virtually obligatory exercise for any prudent decision-maker, particularly one carrying the burden of a fiduciary obligation to ESOP participants.

Q: If a "valuation" is already part of the process, isn't a fairness opinion the same thing?

No. A valuation of the transacting interests may be an essential underpinning for a fairness opinion but it is not the only substance of a fairness opinion. Fairness opinions frequently contain additional disclosures, observations, and assessments concerning the circumstances of, alternatives to, and other key factors surrounding a transaction.

In many cases a fairness opinion reaches beyond the instant economics of a transaction to examine the specific terms and context of a transaction. Valuations are often based on the standard of "fair market value" and are

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constructed using reasonable assumptions and reflections of a hypothetical and rational universe. When an actual transaction arises between specific parties, the situation often includes attributes specific to the parties and the circumstances – in other words, the real world versus the hypothetical world. A well-crafted fairness opinion reaches beyond the hypothetical to examine and document these real world considerations.

Q: What events give rise to the need for a fairness opinion?

The following is a list (non-comprehensive) of the types of events that could give rise to the need for a fairness opinion. A good rule for decision makers concerning the assessment of need for a fairness opinion is if you suspect that any aspect of a transaction is potentially controversial, then an assessment of fairness to the party in question should be considered. The responsibilities and obligations inherent in the ESOP trustee role is serious business.

- The sale and/or issuance of stock to a newly forming ESOP
- The sale of a significant portion or substantially all of the assets or stock of an ESOP company
- The incurrence of significant debt or the financial restructuring (recapitalization) of an ESOP company
- The sale of a significant asset or business segment which is beyond the normal scope of business or corporate activity
- The purchase of a significant asset or business segment which is beyond the normal scope of business or corporate activity
- The liquidation of the ESOP company
- The termination of the ESOP
- The redemption of stock by the company from non-ESOP shareholders
- The changing of corporate entity organization of the ESOP company ("S" election)
- Significant changes to the ESOP plan document
- The commitment of the company to shareholder agreements that place future obligations on the company
- Significant changes in compensation or other financial practices, particularly if such changes are different or contrary to the financial construct upon which a transaction value or ongoing plan valuation is based

Q: Are there specific circumstances that should be considered in the decision to obtain a fairness opinion?

Absolutely. Based on Mercer Capital's experience, events that are potentially controversial, involve a conflict of interest, or involve decisions and actions other than in the ordinary course and timing of business may require a fairness opinion. As with the previous list of events, the following is not all-inclusive. Additionally, most of the following conditions relate to the sale of an ESOP company or the installation of an ESOP.

- The proposed ESOP transaction includes a stock valuation that is different than the valuation at which actual offers for the stock or the company have occurred
- The proposed ESOP transaction includes a valuation that is different than reflected in recent stock appraisals
- The proposed ESOP transaction includes a valuation that is different than stock valuations called for in shareholder agreements (buy-sell, etc.)
- The proposed ESOP transaction requires high levels of debt financing
- The proposed ESOP transaction includes a valuation that relies on changes to historical compensation and other business practices
- The proposed ESOP transaction and its associated debt may compromise the ability of the company to secure operating and growth capital
- The cost of financing does not appear to reflect market rates and/or the ESOP transaction is otherwise unable to achieve third-party (independent) financing
- The proposed ESOP transaction entails financing that potentially dilutes shareholders (such as warrants)

- The proposed transaction valuation is not thorough, methodologically complete, and standards-compliant
- The seller of stock to an ESOP is also the ESOP trustee
- The issuance of stock to an ESOP involves the use of sale proceeds for non-recurring payments to non-ESOP shareholders and/or executives of the company
- The company conducts significant business with parties that are owned or controlled by sellers of stock to a proposed ESOP
- A proposed ESOP transaction is occurring at a time of significant change in company performance (declining revenue and/or profitability)
- A proposed ESOP transaction is occurring at a time of significant change regarding senior management, product and service offerings, closure or discontinuation of certain lines of business or locations, etc.
- Alternative transaction bids have been received that are different in price or structure, thereby leading to an interpretation as to whether the exact terms being offered reconcile to the proposed ESOP transaction valuation
- There is concern that the shareholders, trustees and directors fully understand that considerable efforts were expended to assure fairness to all parties
- The board desires additional information about the potential impact of the ESOP transaction and ongoing plan requirements on the company
- An ESOP company is issuing stock options or other equity-based compensation that could adversely dilute the ESOP's ownership position
- An ESOP company is being sold to a related party or buyer with a current or prior relationship to the company
- An ESOP company is being sold for consideration that is above and beyond that which directly benefits shareholders (including the ESOP) on a pro rata basis (management contracts, non-competes, etc.)
- An ESOP company is being sold to a buyer that intends to employ company executives, trustees, and/or board members subsequent to the closing of the transaction
- An ESOP company is being sold where the company, its board, and/or its executives have not obtained competing bids or assessed alternative strategies for maximizing value and/or achieving liquidity
- An ESOP company has elected not to respond to or to negotiate an offer submitted by a bona fide purchaser of the company

Despite the breadth of the above events circumstances, there are many other situations which likely accompany ESOP transactions and transactions of ESOP owned companies. Your transactions should be thoroughly reviewed from the financial perspective of the ESOP. The transaction process, evolution, negotiations, and other factors that comprise the event (and any circumstances) should be systematically analyzed and documented within the fairness opinion.

Q: What does the deliverable fairness opinion work product look like? What does it contain?

The fairness opinion is a brief document, typically in letter form. However, the supporting work behind the fairness opinion letter can be substantial. This supporting work is often reported and documented in the form of a fairness memorandum that incorporates all material factors, conditions, circumstances, and other considerations which were analyzed, assessed, and disclosed in the development of the opinion. The fairness opinion letter typically makes the affirmative statement that the proposed transaction is fair from the financial perspective of the ESOP.

In the case of a new ESOP or the sale of an ESOP owned company, the fairness exercise virtually always includes a valuation to determine if the ESOP is paying or receiving adequate consideration for the interests it is buying or selling. Generally, the purpose of the valuation is to develop the fair market value of the ownership interest to be transacted. The fairness memorandum also includes all relevant disclosures concerning the transaction, alternatives and potential consequences related to action or inaction regarding the pending transaction, and other assessments that may be specifically requested by the trustee.

In our experience as financial advisors to ESOP trustee, and as an ESOP-owned company, every ESOP situation usually has unique circumstances that require specific assessment. For a confidential discussion about your specific ESOP situation, please contact a Mercer Capital valuation professional.

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ESOP OWNERSHIP IN S CORPORATIONS

Many of Mercer Capital's clients have recognized the value of employee ownership in terms of employee loyalty and motivation as well as the numerous tax advantages to the business and maintain an Employee Stock Ownership Plan ("ESOP"). During the first part of 2001, we have performed hundreds of appraisals for purposes of establishing the value of shares held by ESOPs, proposed ESOP transactions as a result of mergers and acquisitions, and many other purposes. The most interesting development in the ESOP arena, however, is the increasing number of S corporations establishing ESOPs and ESOP-owned C corporations electing to convert to subchapter S status.

Although the provisions of the Small Business Protection Act of 1996 (the "Act") enabled trusts such as an ESOP to be an S corporation shareholder, the Act included numerous provisions that presented significant barriers for S corporations to sponsor an ESOP. In 1997, however, Congress amended the Act to correct technical flaws relating to ESOPs. Most importantly, the revisions to the Act exempt ESOPs from the unrelated business income tax ("UBIT"), making ESOP ownership much more appealing. The revisions also allow S corporations to require cash distributions rather than stock distributions to departing employees to prevent potential disqualification of the subchapter S status (for example, an IRA is not a qualified S corporation owner, and an employee's placing of S corporation stock in her IRA would result in the termination of S status under the Internal Revenue Code).

The valuation on S corporation stock is fundamentally identical to the valuation of an interest in a C corporation. However, a number of valuation approaches require the tax-effecting of earnings/distributions, an adjustment that will convert S corporation operations to a C corporation equivalent basis.

For example, the market approach to valuation includes a variety of methods that compare the subject company with transactions involving similar investments, including publicly traded guideline companies. A direct comparison between an S corporation and a publicly traded C corporation, however, is impossible, as demonstrated in the example in Figure 1.

The S corporation's hypothetical value based on $100 in pretax income and an after tax valuation multiple of 6x is $600, versus the C corporation's value of $360. Say your company operated as a C corporation in 1998, operated as an S corporation during 1999, and operations were absolutely identical in both years. I am sure that you would agree that your Company's value (everything else being equal) did not increase more than 65% simply because of the conversion to an S corporation. The flaw in the above analysis is, of course, the application of an after-tax multiple (which is commonly based upon publicly traded C corporations) on S corporation earnings. In order to allow for a meaningful comparison between your S corporation and the publicly traded C corporations, it is necessary to adjust the S corporation's income for corporate taxes. On a C corporation equivalent basis, net income in the above example is $60 ($100 of taxable income tax-effected at an assumed tax rate of 40%), resulting in a value of $360 for the enterprise.

Mercer Capital understands ESOPs because we ourselves are an ESOP company. We provide annual appraisals for ESOP trustees as well as fairness opinions and other valuation-related services for ESOP companies and financial institutions.

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	S Corporation	C Corporation
Pre-Tax Income	$100	$100
Corporate Taxes	$0	$40
Net Income	$100	$60
Valuation Multiple	6x	6x
Value of the Enterprise	$600	$360

FIGURE ONE

A similar adjustment is necessary when comparing a C corporation's dividends with an S corporation's distributions. C corporation shareholders pay income taxes at their applicable tax rate on dividends received. The S corporation shareholder, however, is responsible for the taxes on his or her share of the company's income, whether a distribution occurred or not. As a result, it is necessary to convert distributions from an S corporation to a C corporation equivalent basis before any valuation inferences can be drawn.

The above examples illustrate that an S corporation's value cannot be derived simply by applying after tax valuation multiples to S corporation net income or distributions. Similarly, we pointed out that there is no S corporation premium resulting simply from the conversion to a subchapter S corporation. If there is no increase in value as a result of conversion, however, what triggered the recent surge in conversions to S corporations?

The key incentive for ESOP ownership of an S corporation appears to be the fact that distributions to the ESOP are tax exempt. The higher the ESOP's ownership stake in the company, the less taxes are paid. If the ESOP is the sole owner of the S corporation, the organization pays no income tax. While we demonstrated that an S corporation's value does not differ from its C corporation peer, this ability to retain, accumulate, and reinvest significant amounts of cash can increase value over time as the operations and earnings grow. During the past year, some of our clients have been able to significantly expand their operations by using the incremental cash flow that resulted from their conversion to an S corporation.

At the same time, there are some potential disadvantages to the S corporation ESOP. First, a Section 1042 "Rollover" (the deferred recognition of gain on the sale of stock to an ESOP) is not available to S corporations. Second, contribution limits for S corporations to pay ESOP debt are limited to 15% of payroll (but increases to 25% if the ESOP contains money pension purchase provisions). Third, S corporations can only have one class of stock, and any distributions must be made pro rata. Since most S corporations distribute an amount at least equal to the shareholders' tax liability and the ESOP has no tax obligation, funds that could be available for reinvestment have to be distributed to the ESOP. However, these funds could be used for a variety of purposes, including ESOP debt retirement, additional stock purchases, or payments to terminated employees.

C corporations with ESOPs desiring conversion to S status must also consider the following:

» S corporations must operate on a calendar year.

» The number of shareholders is limited to 75 (the ESOP counts as one shareholder, no matter how many participants).

» Subchapter S election requires the consent of all shareholders.

» Some fringe benefits paid to 2% or more owners are taxable.

» S corporations using last in, first out ("LIFO") accounting on conversion are subject to a LIFO recapture tax.

» The sale of assets is subject to a built-in gains ("BIG") tax on that sale for a period of ten years after conversion.

» Net operating losses incurred as a C corporation are suspended while an S corporation but may be applied against the LIFO recapture tax and/or the BIG tax.

» ESOPs may be subject to state unrelated business income tax in some states.

ESOP ownership in S corporations can create significant advantages for employers and employees. Employee ownership creates incentives for employees to contribute to "their" company's success and motivate stakeholders to take an active part in the operations of the organization. Business owners have the opportunity to share the successes of their business with employees and reward loyal, long-time employees for their contributions to the business. While employee ownership provides many intangible advantages as compared to more traditional ownership structures, the ability of ESOPs to own a stake in an S corporation may very well be one of the most financially rewarding changes in tax legislation.

SIMPLE TRUTHS ABOUT ESOP APPRAISALS

After years of experience listening to and working with clients and their financial advisors, as well as preparing hundreds of appraisal reports, we have learned a few general and often overlooked simple truths about ESOP appraisals. We share the following six observations in hopes that they will broaden your perspective of business valuation and possibly provide you with some "tips" to assess future appraisals you may review.

1. **An engagement letter should be prepared for client acceptance.** Every ESOP appraisal should officially begin with a proposal or engagement letter specifying what is being valued, the "as of" date, the purpose of the appraisal and the fee arrangement. If the business appraisal firm you have retained does not provide this, request it. While not a requirement, it is generally considered good practice and tends to avoid confusion later in the process.

2. **There is no such thing as a "simple" ESOP valuation.** We are often asked how a particular business might be valued, but unfortunately there is no simple answer to this question. The methodology used to value a company is dependent on a number of factors that will differ, just as companies differ. Be wary of appraisers who provide a short and simple answer to this question.

3. **There is no such thing as "the value" of anything.** Valuation is a range concept tied to another concept, that of "reasonableness." The appraisal of any business may fall within a certain range of values, but the final determination of value must be considered in light of the purpose of the valuation and its overall reasonableness. A valuation purpose that generally illustrates both ends of the continuum is a divorce situation in which the business owner desires the lowest valuation (within reason) and the spouse generally desires a higher value for the business. The concept of reasonableness is tied to number 4 below.

4. **If the valuation starts with reasonable facts and makes reasonable assumptions along the way, chances are the conclusions will be perceived as reasonable.** Bankruptcies are being filed daily for companies whose business plans were based on assumptions and projections that were not possible or reasonable. Make sure you and your business appraiser communicate regarding the sensibility of all assumptions.

5. **The public marketplace provides many objective "markets" as reference points for appraisal of closely held companies.** A thorough valuation conclusion will sit reasonably in relationship to one, or preferably, several of these markers. Peruse the valuation report for this. If it is not there, the appraiser should, at a minimum, explain why an analysis of this nature was not performed.

6. **In a litigation or potential litigation situation, every word written in a report is fodder for cross-examination.** Remember this if you feel your appraiser appears to be particular about the manner in which something is worded. If you have a concern, ask for an explanation as to why the appraiser believes the passage should be worded like it is.

Remembering these common sense yet important points should give you a feel for the general perspective and tone the business appraiser is trying to create. If our perceptions have prompted questions, contact one of our professionals. We will be happy to discuss any valuation issues with you in confidence.

Reprinted from Mercer Capital's ESOP Valuation Advisor, Spring/Summer 1997.

Mercer Capital understands ESOPs because we ourselves are an ESOP company. We provide annual appraisals for ESOP trustees as well as fairness opinions and other valuation-related services for ESOP companies and financial institutions.

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HOW ESOPS WORK

ESOPs are a recognized exit planning tool for business owners, as well as a vehicle for employees to own stock in their employer company. However, most business owners and their advisors are unfamiliar with how an ESOP works. The mechanics of an ESOP can vary somewhat, but there is a basic common functionality to all ESOPs. Below, we discuss the mechanics of leveraged and non-leveraged ESOPs.

Most ESOPs are leveraged and involve bank financed purchases of either newly issued shares, or more often, the stock of a selling shareholder. The Company funds its ESOP via annual contributions as a qualified retirement plan and the plan effectively uses those funds to repay the debt used for the purchase.

Leveraged ESOPs tend to be more complicated than non-leveraged ESOPs. A leveraged ESOP can be used to inject capital into the Company through the acquisition of newly issued shares of stock. Figure 1 illustrates how the initial leveraged ESOP transaction typically works.

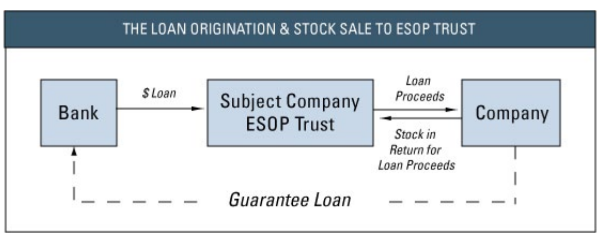

FIGURE ONE

Subsequent to the initial transaction, the Company makes annual tax deductible contributions to the ESOP, which in turn repays the loan. Stock is allocated to the participants' accounts — just as it is in a non-leveraged ESOP — enabling employees to collect stock or cash when they retire or leave the Company. ESOP participants have accounts within the ESOP to which stock is allocated. Typically, the participant's stock is acquired by contributions from the Company — the employees do not buy the stock with payroll deductions or make any personal contribution to acquire the stock. An exception to this norm could involve roll-overs of participant's funds from alternative qualified plans sponsored by the Company. Plan participants generally accumulate account balances and begin a vesting process as defined in the plan. Contributions, either in cash or stock, accumulate in the ESOP until an employee quits, dies, is terminated, or retires. Distributions may be made in a lump sum or installments and may be immediate or deferred. The typical annual flow of funds for a leveraged ESOP is illustrated in Figure 2.

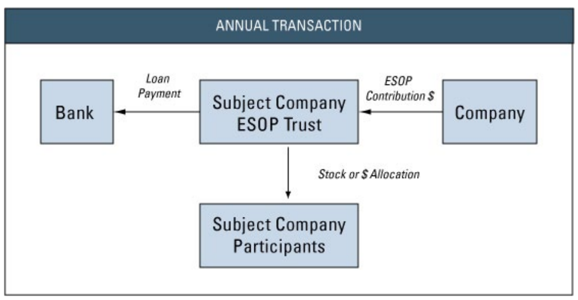

FIGURE TWO

Although non-leveraged ESOPs have certain tax advantages to selling shareholders, they generally tend to be an employee benefit, a vehicle to create new equity, or a way for management to acquire existing shares. The Company establishes an ESOP and either makes annual contributions of cash, which are used to acquire shares

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of the Company's stock, or makes annual contributions in stock. These contributions are tax deductible for the Company. As in a leveraged ESOP, the employee/participant vests according to a schedule defined in the plan document, and stock accumulates in the account until the employee/participant leaves the Company or retires. At that time the participant has the right to receive stock equivalent in value of his or her vested interest. Typically, ESOP documents contain a provision called a "put" option, which requires the plan or the Company to purchase the stock from the employee after distribution if there is no public market for it, thus enhancing the liquidity of the shares. Figure 3 illustrates a non-leveraged ESOP.

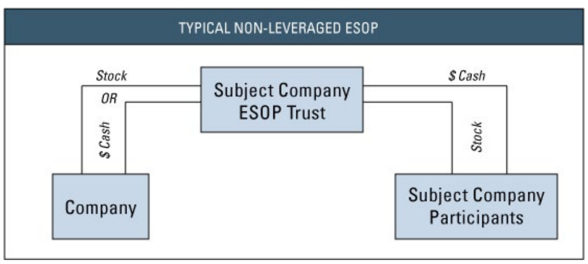

FIGURE THREE

As ESOP participants roll out of the plan at termination or retirement, the ESOP or the Company purchases the employee's plan shares based on the terms specified in the plan document. Plan design and administration are crucial to a successful ESOP experience and require the participation of specialized financial and legal advisors.

As with all qualified retirement plans, there are rules and requirements pertaining to annual contribution limits, vesting, share allocation, plan administration, and other functional aspects that are beyond the scope of this overview.

Sellers of stock to an ESOP may enjoy certain tax benefits related to their sale proceeds, and the Company (the sponsor) may enjoy tax benefits related to its contributions to the ESOP. Thus, ESOPs are often postured by business advisors as a tax advantaged exit strategy.

Mercer Capital is itself an employee-owned firm. We value scores of ESOPs annually and provide fairness opinions and other valuation services on a regular basis to many other plans. To discuss a valuation issues in confidence, contact any of our senior professionals at 901.685.2120.

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Timothy R. Lee, Managing Director the Mercer Capital's Corporate Valuation Group, joined the firm in 1994. He is also a member of the firm's board of directors.

Tim's focus includes valuation and advisory services for Employee Stock Ownership Plans (ESOPs), gift and estate planning, strategic planning, corporate development and reorganizations, mergers and acquisitions, fairness opinions, and controversy matters.

Tim has turnkey experience in ESOP services including formation and adequate consideration analyses, feasibility studies, transaction structuring, fairness opinions, pro forma cash flow modeling, and annual plan year valuations.

Tim also has extensive experience in working with both sellers and buyers in merger and acquisition advisory engagements. He has assisted clients through all phases of the sales process, from conducting strategic alternatives analyses to determine if selling is indeed the best option, to structuring, negotiating, and closing transactions.

Tim is an associate member of the ESOP Association Advisory Committee on Valuation. He speaks frequently on valuation-related topics to associations throughout the nation. He holds the Accredited Senior Appraiser designation from the American Society of Appraisers. He is also the co-author of *A Reviewer's Handbook to Business Valuation* (John Wiley & Sons, 2011).

SELECTED PUBLICATIONS

Co-Author, *A Reviewer's Handbook to Business Valuation*, John Wiley & Sons, Inc. (2011)

Co-Author, *ESOP Valuation*, Chapter 11, "Valuation Issues for ESOP Fiduciaries," National Center of Employee Ownership (2005)

SELECTED INDUSTRY EXPERIENCE

Beverage Distribution	General & Specialty Contracting
Construction	Manufacturing
Distribution	Technology
Retail	Financial Institutions
Food Services	Transportation

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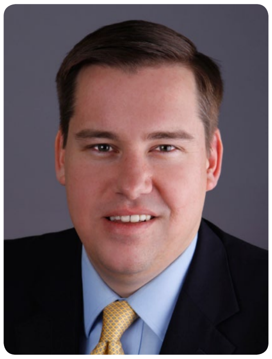

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Nicholas J. Heinz joined Mercer Capital in 2000 and serves as a senior vice president. Nick is a senior member of the firm's Corporation Valuation & Transaction Advisory Practice and leads Mercer Capital's ESOP Team.

He performs valuations of businesses and business interests for Employee Stock Ownership Plans (ESOPs), gift and estate planning, strategic planning, mergers and acquisitions, fairness opinions, and litigated matters. Nick has experience in ESOP analysis, including ESOP formation and adequate consideration analyses, feasibility valuation studies, fairness opinions, post-transaction cash flow analyses, and annual valuations.

In addition, Nick works with both sellers and buyers in various types of transaction advisory engagements. He assists clients through all phases of the transaction process, from conducting strategic alternatives analyses to structuring, negotiating, and closing transactions.

Nick is an officer in the New South Chapter of the ESOP Association and a member of the National Center for Employee Ownership (NCEO). He speaks frequently on ESOP valuation-related topics to groups and associations throughout the nation. He holds the Accredited Senior Appraiser designation from the American Society of Appraisers.

SELECTED PUBLICATIONS

Co-Author, *An Estate Planner's Guide to Revenue Ruling 59-60*, Peabody Publishing (2010)

Co-Author, *Revenue Ruling 59-60 at 50: Rediscover Fair Market Value*, Peabody Publishing (2009)

SELECTED INDUSTRY EXPERIENCE

Agriculture	Healthcare
Building Materials	Telecommunication
Construction	Transportation
Distribution	Veterinary Medicine

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Wendy S. Ingalls, vice president, is a senior member of Mercer Capital's Corporate Valuation Group. She brings to Mercer Capital an extensive and varied accounting, valuation and audit background in private industry, internal auditing and public accounting.

She performs valuations of businesses and business interests for Employee Stock Ownership Plans (ESOPs), gift and estate planning, strategic planning, fairness opinions, and litigated matters. Wendy has experience in ESOP analysis, including ESOP formation and adequate consideration analyses, feasibility valuation studies, fairness opinions, post-transaction cash flow analyses, and annual plan year valuations.

In addition, Wendy has also performed due diligence reviews for various companies for acquisitions, transaction consulting and fairness opinions.

Wendy is a CPA and holds the Accredited in Business Valuation designation from the AICPA. In addition, she holds the Certified Business Appraiser designation from the Institute of Business Appraisers, as well as the Accredited in Business Valuation designation from the American Society of Appraisers.

SELECTED PUBLICATION

Co-Author, *ESOP Valuation*, Chapter 11, "Valuation Issues for ESOP Fiduciaries," National Center of Employee Ownership (2005)

SELECTED INDUSTRY EXPERIENCE

Agriculture	Engineering
Asset Holding Entities	Healthcare
Building Materials	Manufacturing
Construction	Professional Services Firms
Distribution	Retail

MERCER CAPITAL

ESOP VALUATION SERVICES

Mercer Capital understands ESOPs because we ourselves are an ESOP company. We provide annual appraisals for ESOP trustees as well as fairness opinions and other valuation-related services for ESOP companies and financial institutions.

We bring decades of valuation experience to every ESOP engagement. The stability of our staff and our long-standing relationships with clients assure consistency of the valuation methodology and the quality of analysis for which we are known and for which you deserve.

We are active members of The ESOP Association and the National Center for Employee Ownership (NCEO).

Our professionals have been frequent speakers on topics related to ESOP valuation throughout our history.

Each of the senior analytical professionals of Mercer Capital has extensive ESOP valuation experience, providing primary senior-level leadership on multiple ESOP engagements every year.

ESOP Valuation Services

Annual ESOP Plan Valuation	ESOP Appraisal Review
ESOP Feasibility Valuation	Fairness Opinions
Complex ESOP Transactions	ESOP Dispute Resolution
ESOP Sale or Termination Opinions	ESOP Second-Stage Transactions

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About Mercer Capital

Mercer Capital is a full-service business valuation and financial advisory firm. We offer a broad range of services including ESOP and ERISA valuation services, corporate valuation, financial institution valuation, financial reporting valuation, gift and estate tax valuation, M&A advisory, fairness opinions, and litigation and expert testimony consulting.

For over 30 years, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world.