MERCER CAPITAL

CHOOSING A NEW ESOP APPRAISER

15 Reasons Why It Might Become Necessary, How to Go About It, and Understanding the Valuation Process

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CHOOSING A NEW
ESOP APPRAISER

Employee Stock Ownership Plan (“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 whitepaper explores why the Trustee or sponsoring company might opt for a new appraisal provider, how to transition to a new appraiser, and introduces Mercer Capital’s valuation process.

15 Reasons Why A Change in ESOP Appraisers May Become Necessary

There are potentially many circumstances and/or motivations that can compel an Employee Stock Ownership Plan Trustee to seek a new valuation advisor. We highlight 15 potential reasons (presented in no particular order).

1. **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.

2. **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.

3. **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.

4. 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.

5. **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 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.

6. **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.

7. **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. Keep in mind, however, 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.

8. **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?

9. **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?

Shopping the valuation for a targeted treatment or result is a dangerous endeavor

10. **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.

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

12. **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.

13. **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.

14. **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.

15. **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.

The Process of Choosing A New Appraiser

When the decision has been made to choose 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.

Considerations in the Selection Process

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.**

- **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 Trustee's selection decision should be based on the overall qualifications of the business appraisal firm

- **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's Role

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 five 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.

Risks and Benefits of Changing ESOP Appraisers

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.

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 will 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 will indicate 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 will provide a descriptive project overview, outline the Mercer Capital's qualifications and set forth the timetable and fee agreement. Accompanying the Engagement Letter will be 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 will 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 will 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
- Review appropriate corporate documents not normally exchanged by mail or email
- Tour the operations
- Respond to questions from management

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, and should be rigorous enough to withstand scrutiny from government regulators and plan participants

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 will be 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 important 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.

In Summary

The decision to change ESOP appraisers should not be taken lightly. There are legitimate reasons to switch appraisal providers; however, Trustees and sponsoring companies should do their homework and document the process.

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.

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 25 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.

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MERCER CAPITAL'S

ESOP VALUATION SERVICES

Each year, Mercer Capital assists scores of companies and financial institutions with annual ESOP valuations, as well as with ESOP installation advisory, disputes, and fairness opinions.

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

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