

MERCER CAPITAL'S ESOP Valuation Process

The establishment of an Employee Stock Ownership Plan (“ESOP”) is a complex process that involves a variety of analyses, one of which is an appraisal of the Company’s shares that will be held by the plan. The process of a business valuation is often new and challenging to first-time clients. We offer this article outlining Mercer Capital’s valuation process to make the experience less intimidating.

Part of the establishment process is a feasibility analysis to determine whether the company is a good and appropriate candidate for an ESOP. Typically the company engages a number of advisors who coordinate to assist the company and its shareholders in making this determination. A firm that specializes in ESOP implementation is generally hired, as well legal counsel (if the ESOP service firm does not have internal legal resources), an accounting firm, a banker (if there are plans to leverage the ESOP), and an independent Trustee.

An appraisal firm is hired and works with the company and its team of professional advisors to determine the characteristics of the stock held by the Plan and to place a value on the shares. If the company is undecided about whether a plan will actually be implemented and is in the discovery phase of the process, the valuation firm may initially be retained to provide a limited appraisal or valuation calculations and at a later time prepare an appraisal in accordance with the Employee Retirement Income Security Act, the Department of Labor and the Internal Revenue Service guidelines as well as Uniform Standards of Professional Appraisal Practice (“USPAP”).

However, whether the initial estimate of value is a limited appraisal, valuation calculations or a stand-alone appraisal, if the ESOP is eventually implemented there are certain procedures and requirements necessary to develop and prepare a fully documented appraisal that is in compliance with USPAP. The following discussion will provide an overview of the steps necessary to prepare an appraisal.

Introductory Phase

During the initial introduction, professionals of Mercer Capital 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 qualifications of the appraiser and set forth the timetable and fee agreement. Accompanying the Engagement Letter is a comprehensive checklist request for information which is forwarded to the company. 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.

The Valuation Phase

Upon execution of the Engagement Letter by the responsible party, including a response to the checklist request for information, Mercer Capital will begin its 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
- 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 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 (if one has been appointed at the time of our analysis) 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

If you are considering an ESOP, or have one already in place, and would like to discuss any valuation issue in confidence, please give us a call. We know that most companies do not run their businesses to be able to immediately respond to an appraiser's inquiries, but our depth of experience will lead you easily through the valuation process.

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