

Valuation Issues in ESOP Companies

ESOP companies contemplating the implementation of an equity compensation or executive compensation plan must look carefully at its impact on stock value. A thorough analysis of valuation consequences as part of the plan design is critical. In addition, the ESOP's trustees should understand the underlying reasons for the plan's implementation and the expected behaviors the plan is intended to drive. Plans should generally be designed to drive growth and/or profitability goals. In addition, they can be used to both recruit and retain key employees. A well-designed plan will provide meaningful rewards to the plan participants, but not to the detriment of the ESOP participants.

Impact of Equity Compensation and Executive Compensation on Stock Value

The impact on the stock value of a company will vary depending on the type and design of the plan. From a valuation standpoint, one can think of these programs in terms of substance (cash, stock, or synthetic equity) and time (short-term [annual], mid-term [1 to 5 years], or long-term [greater than 5 years]). However, regardless of the nature of the plan, each has the potential to be dilutive to the ESOP if not properly structured.

A cash bonus plan is generally short-term, and its awards are often triggered by achieving both individual and corporate goals. Individual goals are often developed annually with input from both employee and supervisor based on the employee's position, whereas corporate goals are generally tied to financial metrics such as profitability targets. The valuation impact of this structure is generally immediate because the cost of this type of plan will be reflected in a company's earnings in the current year. A well-designed plan is generally ongoing, and its costs must be reflected in any forward-looking financial statements used in calculating the company's stock value.

Equity compensation programs can consist of either stock or synthetic equity awards and are generally mid- or long-term in nature. While the awards may be granted annually, there are generally vesting and/or exercise schedules associated with them that require the participants to hold the awards for some period to receive full value. Hence, the current and potential valuation impacts are much more difficult to calculate, and the costs of these types of plans can vary dramatically.

For example, all else being equal, awards of stock or phantom stock have a greater dilutive impact on stock value than awards of stock appreciation rights (SARs). This is due to the basis from which the equity compensation award is made. A phantom stock award is issued with a basis of zero and has the same impact as issuing a new share of the company's stock. A SAR, however, is issued based on the company's current stock value, so its basis is higher. As such, the cost to the company for the two awards can differ significantly, depending on the stock price the SAR is being issued at, resulting in greater or lesser dilution to the ESOP shareholders. The differences in the dilutive impact can be mitigated by issuing more or fewer units. Therefore, to provide the same value as stock or phantom stock, one would need to issue a greater number of SARs. Take the example in table 5-1.

As one can see from table 5-1, the underlying stock value increases \$10 (from \$50 to \$60) between the time of issuance and the time of exercise. As such, the value of the phantom stock award (\$60) is significantly greater than the value of the SAR award (\$10). Therefore, one cannot simply look at the number of units available for award under a given plan. Rather, it is the value of the awards that is ultimately the key consideration when determining the impact of an equity compensation plan. This is an important distinction and is a key consideration for fiduciaries when evaluating the merits of a particular plan design.

Table 5-1. Impact of Phantom Stock Versus SARs

Current stock price: \$50.00 per share		
	Phantom Stock	SAR
Issue Price	\$0	\$50
Exercise Price	\$60	\$60
Difference	\$60	\$10
Number of Units	1,000	1,000
Value of Award	\$60,000	\$10,000

Benchmarks

To help protect the ESOP from the potential dilutive impacts of an equity compensation plan, a minimum metric or benchmark requirement is often included to trigger the awards. Given that earnings or EBITDA (earnings before interest, tax, depreciation, and amortization) are often used as financial metrics to which a multiplier is applied for purposes of calculating a company's value, many plans require a particular level of earnings or EBITDA before allowing for equity compensation to be awarded. However, this type of protection is only required for certain types of plans.

In the previous example, the company's stock is currently valued at \$50 per share. Therefore, the value of the phantom stock award is \$50,000 (\$50 per share x 1,000 units) upon grant. All else being equal, the value of the company just declined by \$50,000. If there were a minimum earnings or EBITDA target in place before an award could be granted, the company would have greater assurance the stock value would increase even with the award being granted. The mechanics of this analysis are discussed below.

With a SAR award, the value is zero at the grant date because the underlying stock price must appreciate for the SAR to have value. As such, there is a built-in safeguard in that there is only value to the award if the stock value increases, which generally would require a minimum level of earnings or cash flow to drive stock value growth. Therefore, a minimum target may not be required for this type of plan.

Projecting the Value of Equity Compensation Awards During Plan Design

Understanding the likely value of awards under a plan is a key element in designing a meaningful and fair equity compensation plan. A compensation study allows one to target a specific compensation level for each participant or group of participants in the equity compensation plan. The targeted compensation levels provide a sanity check on the plan's overall design.

Take, for example, the CEO of the company in the example above. This company is in the widget manufacturing industry, where CEOs receive cash and bonus compensation totaling \$400,000 to \$500,000 annually. The CEO receives a base salary of \$250,000 and has a bonus plan that allows him to receive up to \$100,000, so his total potential compensation is \$350,000. The company would like to put an additional equity compensation plan in place that will allow him to end up within the industry range of \$400,000 to \$500,000 annually. Thus, the plan must provide him with an annual award value of \$50,000 to \$150,000. By analyzing the company's strategic plan and using the associated forecast financial statements, one can reasonably estimate what the company's stock value will be in subsequent years if its management team can meet the projections. One can then use the expected stock values to determine the value of the awards under the new equity compensation plan under various growth scenarios.

Going back to the example above, if we assume the stock price is going to grow from \$50 to \$60 over the next three years based on the current strategic plan and forecast financial statements, we can calculate the likely value of the award if the company achieves its projection. In this instance, the plan design calls

for the issuance of 10,000 SAR units to the CEO and requires that the SARs are not exercised until the end of year three. If the company meets the projection, the value of the CEO's SAR award will be \$100,000 ($\$60 - \$50 = \$10 \times 10,000$ units) at the end of year three.

In this example, the company achieves the desired outcome for the CEO's compensation if it meets its projections. Is this a good deal for the company? For the ESOP participants? Of course, the answer is "it depends." If the company's board of directors is concerned about retaining the CEO and recognizes his current pay is below-market, it may argue the projections are not achievable without this individual and thus the new plan is a good deal for all parties, even though it appears on the surface to be diluting future stock values.

However, if the perception is that the projection should be easy to achieve regardless of who is at the helm, and the shareholders have an expectation of more significant stock growth, the award might be adjusted to provide a smaller number of units such that the desired payout is only achieved by driving more significant stock value growth.

Suppose that instead of 10,000 units, the plan calls for a 5,000-unit award. If the CEO can drive the company's stock value to \$75 per share instead of the \$60 under the current plan, the award value would be \$125,000 ($\$75 - \$50 = \$25 \times 5,000$ units). Under this scenario, both the shareholders and the CEO benefit from the enhanced stock value.

If this were a phantom stock plan, the award might be tied to the achievement of an earnings or EBITDA target used in the projection. This would help ensure the award is not dilutive to the expected future stock values. Often such awards are scaled based on outperforming the projection. For example, if EBITDA were projected to be \$5 million, the award would be granted only if the company exceeded the projection. There may be an escalator that calls for additional units to be granted based on exceeding the target by 10%, 15%, and so on.

These examples illustrate the need for the plan design to be focused on very specific objectives and for the compensation plan to be clearly tied to the overall strategic plan. From a fiduciary standpoint, whether the compensation plan is dilutive or additive to stock value, and why, is a critical issue.

Financial Statement Impacts

The previous examples oversimplify the valuation issues by ignoring the effect of the equity compensation plan on the company's financial statements. Each award under the plan will affect the income statement and balance sheet of the company. As a result, the analysis of the equity compensation plan must include its effects on the financial statements when projecting the future stock values and values of the awards. This is an iterative process since the financial statements drive the stock value, the stock value drives the value of the awards, and the value of the awards affects the financial statements and stock values. Great care must be taken to understand the accounting for different types of plans. There are different rules with regard to timing of expense recognition and the associated liabilities that are booked on the balance sheet depending on the type of equity compensation used and its associated vesting schedule.

Conclusion

In short, a well-designed plan will not dilute the ESOP's or other shareholders' economic stakes. An effective design will provide meaningful benefits to the participants in the compensation plan upon achieving measurable performance goals. If the performance goals are well aligned with the company's strategic plan, the achievement of these goals should drive stock value growth and eliminate any economic dilution to the ESOP or other shareholders.

About the Author

[Chris Staloch](#) has been with Chartwell since 1997 and leads the firm's consulting practice. In addition to advising management teams and boards on issues related to ownership and compensation strategies, capital structure, and firm valuation, Chris works frequently with Employee Stock Ownership Plans, providing independent financial advisory services to ESOP trustees and other corporate fiduciaries.

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