TENDER OFFER VALUATION ISSUES FOR ESOP TRUSTEES

Prepared for the Annual Conference of the
Ohio Employee Ownership Center
April 15, 2005

BUSINESS VALUATIONS, INC.
8240 CLARA AVENUE
CINCINNATI, OHIO 45239
513-522-1300

TENDER OFFER VALUATION ISSUES FOR TRUSTEES AND OTHER FIDUCIARIES

The tender offer price may be, and usually is, considerably above the current ESOP value per share. Do ESOP Trustees and other fiduciaries with respect to shareholders have to accept that higher price and sell the Company?

The answer is NO! Get a new valuation reflecting the changed circumstances.

There are many reasons why ESOP share values do not represent values comparable to acquisition values. For one, the STANDARD OF VALUE is different. ESOP appraisals are required to take into account any disadvantages from lack of control and any risks from a lack of marketability. Also, ESOP values cannot take into account future acquisitions or merger with another company. Furthermore, ESOP values usually take into account cash outflows such as ESOP debt reduction and the repurchase obligation that acquisition values do not.

Considerations such as these tend to raise the investment risk level for ESOP shareholders or reduce the level of cash flows available to the ESOP shareholders. Both raising the level of risk and lowering the level of cash flows reduce the value of the shares for ESOP participants.

ESOP Trustees and other fiduciaries with respect to shareholders need to determine what their Company's acquisition value is so as to produce an apples-to-apples comparison. Only then can they make an informed and responsible decision as to the fairness of the offer.

ESOP appraisals are conducted under the FAIR MARKET VALUE standard of value which defines value as: "the price at which an asset would change hands in a transaction between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for that asset." Some definitions add the comment that buyer and seller are hypothetical and not specifically identified parties in the transaction.

ESOP appraisals are conducted under restrictive PREMISES OF VALUE. Such appraisals assume the Company will remain independent and continue as an ESOP company indefinitely. ESOP appraisals may need to take into account the disadvantages and risks of a lack of control and of a lack of marketability for the shares held by the ESOP.

LEVELS OF VALUE

STRATEGIC BUYER OF CONTROL
Includes expected future cost savings and possible synergies
Fair Value ... not Fair Market Value Standard

▲ Premium for higher cash flows
▼ Discount for lower cash flows

FINANCIAL BUYER OF CONTROL
Fewer expected future cost savings and no synergies
Fair Market Value Standard

▲ Premium for higher cash flows and no agency costs
▼ Discount for lower cash flows and agency costs

MARKETABLE MINORITY INTEREST
No expected cost savings (unless specified) and no synergies
Fair Market Value Standard

▲ Premium for ready active market
▼ Discount for possible long holding period and no dividends

NON-MARKETABLE MINORITY INTEREST
No expected cost savings and no ready market for stock
Fair Market Value Standard

Discounts and Premiums should be justified by some demonstrable evidence of economic value to be lost or gained and by risk to be shed or assumed.

To transform an ESOP value to an Acquisition value the following may take place:

Eliminate any lack of marketability or lack of liquidity discount
Eliminate any minority interest adjustment or discount
Control shares carry no agency costs
Control shares have full access to the free cash flows

A. Some of which may currently be paid out as extra compensation to senior executives (bonuses, related company fees, etc.)
B. Some of which may currently be paid out as deferred compensation or profit sharing, or other perks to senior executives
C. Some of which may currently be paid out as above industry norm retirement plan/ESOP contributions or for repurchases of ESOP stock
D. Some of which may currently be paid out as compensation for unneeded employees or unneeded outside services, etc.
E. Some of which may currently be paid out foolishly or needlessly

Acquisition of control often means the elimination of the ESOP and its expenses for appraisals, administration costs, education and publication costs, legal fees, trustee fees, etc. It usually also means that the cash flows now assumed directed to reacquiring shares under the repurchase obligation or paying down the ESOP debt will be available to the acquirer.

If the offer is from a strategic buyer, like a competitor, then certain synergies can be taken into account. Once the specific buyer is revealed, it is usually obvious that some cost savings will be realized by the acquirer who will merge the ESOP company into his company. Such savings include the elimination of certain executive and staff salaries and bonuses. The ESOP company's sales force may be let go and the product sales and distribution handled by the acquirer's sales force and distribution system. Other overhead may no longer be needed by the acquirer. The effect on earnings and cash flow from the elimination of these costs can be huge and help to justify a large price premium over the ESOP per share value. Other synergies such as making the combined company larger or more diversified with a favorable effect on its cost of capital are harder to quantify but a useful to take into account in any negotiations. And negotiate you must.

Financial theory would say that the acquirer should not have to pay for what he brings to the table. But, in the real world they usually do to a greater or lesser degree. The huge premium over the trading price offered by buyers of publicly traded companies mostly represent these differences in earnings and cash flows that will be available to the acquirer as a result of combining the ESOP company into the acquiring company. Other less quantifiable factors may also come into play such as competitive position in the industry (with or without the acquisition) or just CEO ego and empire building.

There can be no guarantee that a new valuation will produce a substantially higher value for the shares. That will depend on the facts and circumstances of the situation. It will depend on industry conditions, your company's position in the industry, your sales and profit trend, etc.

COMPLICATIONS

If the tender offer is from a financially oriented buyer who intends to keep the Company independent, then his offer price may be less than what a strategic buyer may offer. An appraiser may still consider such an offer as fair to the ESOP and its participants. However, the Trustee and the appraiser will not necessarily consider it fair if there is a likely strategic buyer available. The Trustee and other fiduciaries may need seek a strategic buyer or seek other offers in any case whether the offer comes from a financial or a strategic buyer.

If the tender offer price is for stock or for cash and stock rather than just cash, then the Trustee, other fiduciaries, and the appraiser will have to determine the fair value of the offerer's stock as well as the fair value of the ESOP company stock. This situation can arise for private companies as well as public companies. Cash is not risky. Stock is risky. There are many examples of companies legitimately accepting an apparently lower price rather than an apparent higher price due to the perceived higher risk of the higher priced offer. The offer prices need to be converted to a risk adjusted basis. Witness the current Quest/MCI/Verizon struggle.

If you are Trustee of a 100% ESOP owned company with Sub Chapter S tax status, then you should take into account the value to the participants of the advantages to the Company and to the participants of the absence of income taxes. The advantage to the Company can be a stronger competitive position and/or the ability to fund acquisitions, higher levels of marketing, and higher levels of R&D. The advantage to the participants can be the availability of more cash flow to be contributed or distributed to the ESOP. These advantages will likely disappear when the ESOP Company is acquired. The valuation for normal ESOP purposes does not take these cash flow advantages into account specifically, because they may or may not become apparent over time depending on the use of those added cash flows. If invested appropriately, the value of an ESOP S Corp will grow faster than an ESOP C Corp and be reflected in higher share values in the future.

In any case, a considerable due diligence effort is required on the part of the Trustee and all fiduciaries with obligations to shareholders. New valuations and a fairness opinion are required. Negotiate. Without a complete and conscientious effort, you may end up in court with the Judge (or plaintiff's attorney) asking: did you consider this? did you consider that? did you seek other offers?, etc.