

## Advisory Committee on Valuation

### Floor Price Protection

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*Due to the impact on share price after highly-leveraged, second-stage ESOP transactions, it is increasingly common for trustees to negotiate stock price protection for selected classes of employees so they are not adversely affected by this predictable stock price decline. This protection typically takes the form of a “floor price” for retirees that is put in place while the company’s stock price is most impacted by the buyout debt load. This article discusses the situations, mechanics, fairness and considerations related to such “floor price protection.”*

It is common in a second-stage, leveraged ESOP transaction for the equity price to decline as a result of the debt taken on from that stock sale. While this should benefit employees over time due to future stock allocations, it can have the opposite effect for those participants separating from the business and receiving distributions in the near term. The magnitude and expected duration of a stock price decline can be reasonably estimated by analyzing the amount of debt taken on, the debt payback period and the anticipated overall rate of enterprise growth. Generally speaking having more debt, a longer payback period and slower predicted growth will prolong this effect, all other things being equal, and vice versa<sup>1</sup>.

Floor price protection (“FPP”) is a negotiated agreement between the ESOP trustee and the sponsoring company for the company to buy back stock from a specified sub-group of participants (and not the ESOP directly) at more than fair market value under agreed-upon circumstances. This provision lasts for a limited time period (again, to be analyzed and negotiated) and applies to only an agreed-upon group of employees, *i.e.* those participating in the ESOP at the time of the second stage transaction (on a non-discriminatory basis).

While there is general agreement among companies and trustees that FPP is a good thing, two potentially conflicting perspectives can complicate this conclusion. For retiring employees of course, there is agreement that adopting a floor price is “fair.” Who wants long-term, retiring employees to take a reduction in their benefits simply because they are retiring at the “wrong time?” The ESOP trustee, however, has a tougher analysis to complete, as it needs to assess whether or not this subsidy – taking value from one group of shareholders and giving it to another - is fair for ALL plan participants. One can imagine a set of facts where the FPP is immaterial and therefore not controversial, e.g., a young workforce with very few retirees. Conversely, one can also imagine the opposite where the subsidy is very expensive and transfers a substantial amount of value, thereby harmful to the non-benefitting participants.

In order to minimize any potential adverse impact of FPP agreement, an analysis must be completed and consideration given to the design and mechanics of FPP.

#### Floor Price Protection Considerations

It is vital when designing FPP to analyze the company’s *expected future* performance in the context of the debt to be taken on in order to answer some important questions:

1. How long should the floor price be in place?
2. What should the floor price be?
3. Who should be eligible for FPP?
4. How much will the FPP cost the company over and above the normal repurchase liability?

The duration of the FPP should be determined by assessing the expected stock price performance and the estimated cost. Of course, the longer FPP is in place, the larger the expected cost, so it is unusual to see FPP go for more than 3-4 years.

The first step is assessing the resulting impact on stock price from the leveraged transaction. Estimating company performance starts with management’s assessment of the operating risks and opportunities. This operating forecast is then adjusted to reflect the company’s new capital structure and from there, a stock price can be derived.

After completing this model, we can begin to assess how long it takes for the stock to rebound to its pre-transaction price and therefore back into a FPP period. This rebound is a function of the amount of new debt and its payback period, as well as the overall growth rate of the enterprise. This rebound period will be different for every company, so it is critically important that realistic assumptions are used and sensitivity analysis completed, to get a good picture of how the stock price will perform during the FPP period.

Once the stock price performance has been assessed, a floor price per share can be set. A good starting point is most recent pre-transaction ESOP valuation, since this is the last share price shown on the ESOP participants’ benefit statements. Whether this price or any other is selected it will also need to be decided if the “Stated Floor Price” is fixed or variable. Most companies and practitioners prefer a variable floor price so it accounts for overall company performance but to not the transaction debt. Using a variable method, we have a “Stated Floor Price” and an “Adjustment to Floor Price” with the “Adjusted Floor Price” compensating for reductions in overall enterprise value, if any.

Next, the decision about FPP eligibility is made. Most practitioners recommend the FPP apply only to payouts for death, disability and retirement of active participants. Pre-retirement participants are typically excluded from FPP on the theory (and analysis) that their benefits would not be paid out until most of the buyout debt has been repaid. This assumes the ESOP has the typical five-year waiting-period language, so the rationale for supporting FPP for this group is substantially mitigated by time.

After the group of covered employees is selected, the mathematics of estimating the total FPP cost and final assessment

	Floor Price Protection Period			
	12/31/2009	12/31/2010	12/31/2011	12/31/2012
Equity Value (before ESOP debt, 000's)	\$ 156,781	\$ 154,256	\$ 149,834	\$ 164,025
Per Share Prices				
Stated Floor Price	\$ 14.40	\$ 14.40	\$ 14.40	\$ 14.40
Adjusted Floor Price (AFP)	14.40	14.20	13.81	14.40
Appraised Price (FMV)	6.51	7.45	8.78	12.45
"Cost" of Price Protection (AFP-FMV)	\$ 7.89	\$ 6.75	\$ 5.03	\$ 1.95
Estimated Share Buyback (# shares)	49,770	45,856	52,348	22,983
Total Shares Outstanding	7,954,000	7,954,000	7,954,000	7,954,000
as a % of total shares outstanding	0.6%	0.6%	0.7%	0.3%
Estimated Cost of FPP	\$ 392,685	\$ 309,528	\$ 263,310	\$ 44,817
estimated cost as % of total equity value	0.8%	0.5%	0.4%	0.0%

of its relative fairness can be made. Once this analysis has been reviewed, adjustments can be made in FPP design to balance the benefits and limitations of this provision. The following table summarizes such an analysis. The Stated Floor Price is \$14.40 per share, which was the per share value from the ESOP's prior valuation. This price gets adjusted based on the company's performance but not for the new ESOP indebtedness. In the example above, because the company's overall performance is projected to decline in 2010-2011, there would be downward adjustment of the floor price. Similarly, the adjustment in 2012 would be positive, based on this forecast, however since the FMV is still below the Stated Floor Price, this upward adjustment is ignored.

### Conclusion

This article has attempted to provide a *general* discussion and *framework* for assessing and designing FPP. There are many other variables that can go into this analysis, but those highlighted are of primary importance.

When considering and negotiating FPP, it must be acknowledged – by the company and trustee - that by paying out benefits to a selected group of participant/shareholders at more than fair market value, value is being taken away (at least temporarily) from other shareholders of the company both inside and outside the ESOP. Critical to minimizing any potential adverse consequences of the FPP is: 1) limiting the duration of a FPP, 2) carefully selecting the eligible group, and 3) creating adjustments in the stated floor price so as not to overpay when the overall company performance goes down. Analyzing these factors, and others, in good faith will help you determine what is best for your company, plan participants and will help create a provision that is fair to all participants and shareholders.

#### (Footnotes)

<sup>1</sup> It should be noted that if a "going 100% ESOP" transaction is structured as a redemption, a stock price decline would not be expected, since the price per share would reflect a reduced number of shares in addition to the new debt load. However, it is also very common in a "going 100% ESOP" transaction to combine a redemption and ESOP share sale to minimize the stock price decline while creating new suspense shares for future allocations. In these cases, FPP may or may not be necessary.

*The author of this article is a members of The ESOP Association's Advisory Committee on Valuation. The author reviewed this article with Committee Chair, Kathryn Daly, ASA, Columbia Financial Advisors, Inc., Portland, OR.*

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