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ESOP's Fables

by: Nevin Sanli and Tracy Washburn

Employee Stock Ownership Plans ("ESOPs") have long been regarded by company owners and employees as confusing, intimidating, and detrimental to the welfare of an enterprise. Critics argue that ESOPs fail to improve corporate performance, are simply strategies to defend a company from a hostile takeover, and may even lead to a company's demise.

The morals from Aesop's Fables, however, are instrumental in exposing these misconceptions as mere myths. First told in ancient Greece by the famed storyteller Aesop, these tales continue to teach contemporaries: (1) the power of unity; (2) the need to tailor solutions to specific problems; (3) the importance of diligence; and (4) there are two sides to every story.

WHAT IS AN ESOP?

An ESOP is an employee benefit plan that provides employees with stock in their corporation. ESOPs are similar to other tax-qualified employee benefit plans in that contributions made into an ESOP are tax deductible for the corporation and the plan's assets may grow tax-deferred. ESOPs, however, are unique in that they may invest primarily in the stock of their own company and the company may borrow money to fund the purchase of the ESOP's assets.

In its most basic form (an un-leveraged ESOP), the company buys its own stock, which it then gives to a trust (i.e., the ESOP) that holds the stock for the benefit of the employees. The stock purchased by the company for the ESOP may be acquired from an existing shareholder(s) or may be newly issued stock. In a leveraged ESOP, however, the ESOP borrows money to purchase the company stock. The company then makes cash contributions to the ESOP so that it can repay the ESOP loan.

Good candidates for establishing an ESOP are companies that:

- ◆ Have a large enough payroll to justify the costs to establish and administer an ESOP;
- ◆ Can afford the annual contributions and the initial costs to establish an ESOP; and
- ◆ Have a management team open to sharing ownership with employees.

ESOPs provide strong tax advantages for both the company and the selling shareholder. First, in a leveraged ESOP, both interest and principal payments on the ESOP loan are

tax-deductible. Second, if the ESOP purchases existing stock, the selling shareholder(s) can defer capital gains on the sale of their stock so long as the proceeds from the sale are reinvested in similar investments (e.g., domestic publicly traded stock, etc.).

In addition to providing tax advantages, ESOPs often improve worker productivity and the company's profitability by aligning the interests of the company's employees with its owners. Perhaps the greatest benefit for the employees is the ability to share in the company's success.

While the benefits of ESOPs are many, a lack of their understanding has engendered many negative myths. The following morals, gleaned from Aesop's Fables, will help clarify the truth shrouded by the falsehoods.

IN UNITY THERE IS STRENGTH:

In "The Bundle of Sticks", a father gives his three quarreling sons a bundle of three sticks and has each son try to break the bundle. None can do it alone, yet when the father divides the bundle, giving one stick to each boy, the sticks are easily broken. This shows that teamwork yields greater results than working alone.

The most prominent myth about ESOPs is that broad-based ownership fails to improve corporate performance because employees are not interested in ownership. Numerous studies, however, have shown that, when combined with a culture that embraces "participative management," broad-based ownership is a powerful way to improve a company's operating performance.¹ By themselves, however, neither participative management, nor broad-based ownership, accomplishes much. In order to develop a "high performance" ownership culture, it is stressed that a company must ensure that:

- ◆ Employees understand the meaning of ownership. They move beyond "I'm an owner" to the notion of a community of owners.
- ◆ Employees can communicate openly in all directions.
- ◆ Employees understand and are committed to the company's business goals.

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- ◆ The company provides extensive financial education and gives employees ways to affect corporate outcomes.
- ◆ The company's needs and the individual's needs continue to be balanced as employees understand how individual actions affect the company as a whole.²

When employees feel they are partners in the company's future, not merely paper owners, a true alignment between their interests and those of management is achieved, resulting in a stronger, more solidified workforce.³

THE METHOD SHOULD SUIT THE CIRCUMSTANCES:

In "*The Donkey and the Load of Salt*," a donkey and a merchant are traveling to a marketplace to sell their goods. On the way, the donkey loses half of his load when he accidentally slips into a river. On the way back, the donkey decides to do the same thing in order to make his load lighter, yet the new load consists of sponges and only adds weight. By attempting to utilize a method that worked one time, he did not consider that the circumstances may have changed, and that his work actually doubled as a result of using the incorrect method.

There are many misconceptions surrounding the reasons a company adopts an ESOP as part of their overall business strategy. Some of these include using the plan as a takeover defense, a buyout of a failing company, or as an exchange of stock for labor concessions. In truth, these reasons explain less than 6% of all ESOPs.⁴

While the reasons for establishing an ESOP vary on a case-by-case basis, ESOPs are often formed by successful companies to:

- ◆ Create a liquidity event for a departing shareholder as part of their exit-strategy;
- ◆ Diversify the investments of a majority shareholder;
- ◆ Raise capital on a pre-tax basis to fund existing operations or an expansion;
- ◆ Improve morale and reward employees;
- ◆ Privatize a government entity;
- ◆ Sell a subsidiary or division; or
- ◆ Take a public company private.

Given the diversity of motivating factors, it is essential that companies considering an ESOP retain well-qualified ESOP experts that can complete the ESOP while helping them attain their goals.

DON'T NEGLECT SMALL THINGS WHEN THINKING OF GREAT ONES:

In "*The Astrologer*," a man becomes famous when he can see the future in the stars. One day as he is walking and looking into the sky for guidance, he falls into a hole in the ground. Though he could predict the future, he could not see the hole at his feet. The astrologer is thereby reminded that taking time to concentrate on things big and small is the way to success.

Attention to detail is a critical aspect of establishing an ESOP. Because of the tax advantages and labor issues surrounding ESOPs, both the U.S. Internal Revenue Service and the U.S. Department of Labor closely scrutinize ESOPs. As a result, ESOPs are complex transactions, which, if not structured correctly, can result in unrealized tax savings, unnecessary government audits, as well as costly litigation. While many attorneys, financial advisors and business appraisers provide ESOP-related services, few have the education, resources, and most importantly, experience to guide their clients through the complex regulatory environment. It is thus imperative that companies establishing an ESOP retain an independent appraiser that routinely provides valuations in highly scrutinized situations and that has extensive litigation experience. Taking these steps will significantly decrease the potential for a dispute

and provide protection, should the valuation ever be challenged.

THERE ARE TWO SIDES TO EVERY STORY:

"*The Man and the Lion*", was written by Aesop to convey the importance of listening to both sides of a situation before drawing a conclusion. In this fable, a lion and a man are arguing over who is stronger. The man proclaims that humans are because of a statue illustrating a man conquering a lion. The lion counters that it might have been a different story had a lion made the statue.

Perhaps the worst reputation attributed to ESOPs comes from the failure of United Airlines ("UA"). In 1995, UA formed its ESOP and experienced an incredible year: UA outperformed the S&P by 67%, sales per employee increased 10%, and employee grievances declined 74%.⁵ By 2000, the ESOP was terminated, UA was embroiled in bitter labor disputes, and UA was plagued by poor employee morale and excessive flight delays.

Many of UA's problems could be traced, in part, to management's reluctance to create a permanent ownership culture. First, UA's ESOP was structured so that UA would only make contributions to the ESOP for five years. This had two effects. First, employees did not see the creation of the ESOP as a permanent benefit of their employment. Second, employees joining UA after the last year of the ESOP were never able to join the ESOP. This resulted in a two-tiered labor force: employee owners worked along side regular employees. As a result, labor negotiations became more contentious and employee morale plummeted.

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FIRM PROFILES

Adam Smith



Adam Smith is a financial analyst in SP&H's Los Angeles office, where he has worked since 2000 on valuations and analyses for ESOPs, marital dissolutions, loss of goodwill, economic damage estimates, and mergers and acquisitions. Mr. Smith also has extensive experience in conducting market and industry studies, performing fairness and solvency opinions, and developing financial projections. He attended the University of California at Los Angeles, where he achieved a Bachelor of Arts degree in Business and Economics and a Minor in Accounting. He is currently working towards obtaining the Accredited Senior Appraiser (ASA) designation, business valuation discipline, from the American Society of Appraisers. Mr. Smith lives in Los Angeles, and can be contacted at 310/571-3400, or asmith@sphvalue.com.

Tracy Washburn



Tracy Washburn joined SP&H's marketing team in July, and has since been busy organizing events, writing articles for SP&H's newsletter and other publications, and attending various seminars across California and Arizona. She is a member of the International Right of Way Association, the California Redevelopment Association, the Los Angeles Venture Association and the Association for Corporate Growth, San Diego and Los Angeles Chapters. Tracy earned a B.A. degree with honors in Sociology from the University of California at Santa Barbara. She received various accolades, including induction into the UCSB Dean's List, the Phi Beta Kappa national honors society, and admittance to the Department of Sociology's Honors Program. Tracy is based out of SP&H's Los Angeles office, and can be reached at 310/571-3400, or twashburn@sphvalue.com with questions, comments, or article submissions.

SP&H Client to Revolutionize the Digital Image Industry

*Twas the night before the image revolution, and all
through the advertiser's house
Associates were searching the Internet for digital pictures; fran-
cantly clicking away at the poor computer's mouse
The chains of usage fees attached to the images began to take
hold, clanging together in the air
The ties of negotiations were strewn just about everywhere
They began to reflect fondly of being nestled all
snug in their beds
Wishing there were an easier way to obtain images without a
foreboding sense of dread
With Getty Images and Corbis comprising the image
industry's industrial cap
All those wishing to obtain stock photography were thereby
placed in an option-less trap
Then out of the blue, someone new on the scene
generated such a clatter
The dominating digital imaging companies hired people
to see what was the matter
Away to their agents, they flew in their privately
owned Lear jets in a flash
They were used to being unquestioned, unchallenged,
and dominating the cash
Their plasma, high-definition computer screens
highlighted a new kind of show
As the glistening 24-7 Digital symbol appeared all aglow
And then, what to their wondering eyes should appear
But Express RP, and a one-time, one-price,
flat image fee per year
No more complications, negotiations, or limiting evil tricks
Campaign-ready images were instantly
available with just a little click!*

The stock imagery industry has experienced little change over the past sixty years, enabling two companies, Getty Images and Corbis, to comprise and control over 80% of the industry. The existing process of finding and purchasing pictures and other media is complicated, time consuming, limiting, and expensive.

This results in much frustration and puts many advertising firms, publications, and graphic designers in tough positions as deadlines approach, their images become outdated, and other problems arise.

That is about to change with the presence of 24-7 Digital, Inc., in the marketplace. Jerry Skillet, founder and president of the company, is revolutionizing the existing image industry with a new product-licensing paradigm he coined 'Express RP'. This new system will act to simplify the process of obtaining digital graphics for use in print, electronic, and general advertising, referred to as stock photography. It works like this: One image, one price, one year of unlimited use for each specific client.

What's more, all of these images are produced using a concept that Mr. Skillet created called, "cinematic photography." This is a cutting-edge, state-of-the-art approach that generates high quality products unique to the advertising world. 24-7 Digital, Inc., offers a broad collection of pictures that defy many rules of traditional photography, capture the current trends in advertising, and make for an exclusive, easy-to-obtain project for designers, art buyers, and other associated professionals.

If Mr. Skillet's new approach to digital imagery is not enough to penetrate the market, perhaps taking his company public will make for an interesting challenge to the other companies in the industry. His primary goals for going public are to create liquidity for investors and to utilize capital from the stock to acquire additional digital library sources. The presence of 24-7 Digital, Inc., in the publicly traded stock market could result in a variety of changes to the way stock photography is licensed and sold to clients in the future.

Within the next few years, Mr. Skillet predicts that all stock photography and film imagery will be licensed and produced using the Express RP system. A majority of the top 500 advertising agencies have already begun using this new process of obtaining digital imagery, helping propel the revolution along as it continues to change the face of the stock photography industry.

You can visit 24-7 Digital, Inc.'s website at www.247digital.com.

Hydrogen Ventures and SP&H Team Up to Help Clean the Environment

Coal, oil, and natural gas currently supply 85% of America's energy. Emissions of carbon dioxide from these non-renewable power sources have been implicated in contributing to global warming. Steps need to be taken to reduce our reliance on fossil resources both through efficiency improvements and increased use of renewable energy technologies. That is where Hydrogen Ventures, LLC, comes in. Founded by Elias Azrak in 2001, Hydrogen Ventures is a California-based company that seeks to invest in businesses that promote the use of advanced energy technologies, providing management consulting and financial services to early and development stage companies within the venture community.

As it stands, energy demand is increasing faster than efficiency improvements can handle and keep up with. The environmental effects of using harmful energy sources are likely to worsen in the future. Therefore, Hydrogen Ventures feels that solar, wind, and geothermal renewable energy sources are more efficient and healthier on the atmosphere than those currently used, and will represent a significant share of primary energy production in the future. Hydrogen Ventures is striving to become a major part of

America's energy portfolio, attempting to implement their ideas one start-up company at a time.

The company partners with professionals in various business and technology-related industries to offer services and other resources for clients. Hydrogen Ventures has brought in SP&H to provide extensive assistance with building business plans, financial strategies, management services, and technology developments to companies that desire to make the transition to a clean energy environment. As an example, Hydrogen Ventures anticipates increased reliance on strategic investments and corporate consolidation in the energy sector, which are core specialties of SP&H; SP&H will offer its expertise in business valuations and strategic planning, due diligence, and analysis services to companies who desire to expand on Hydrogen Venture's vision.

Hydrogen Ventures is currently working with a number of companies in the transportation as well as energy industries who are striving to bring solutions to the marketplace.

All of us here at SP&H are thrilled to be working in collaboration with Hydrogen Ventures and warmly welcome them into our network of friends.

Please visit their website at www.hydrogen.la for more information.

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Southwest Airlines, however, combined its employee ownership plan (which is similar to an ESOP) with a strong participative management culture. The airline proudly states that it "puts their employees first, the customers second, and shareholders third."⁶ The company's employees work in teams to decide policy, information is shared freely, and employees are empowered to make decisions. Southwest Airlines now has, "a market capitalization greater than the major airlines combined."⁷ Thus, Employee ownership can and does work in the airline industry, demonstrating there are two sides to every story.

IN CONCLUSION:

An ESOP provides a structure and foundation for cultivating an organization that embraces cooperation, teamwork and success. In addition, ESOPs provide significant tax advantages and allow for a continuity of management. Finally, sharing ownership with employees can increase morale and productivity, making the company more competitive and profitable.

¹Employee Ownership and Corporate Performance, NCEO, 2002.

²Vanderslice, Virginia. Creating Ownership When You Already Have Participation, NCEO, 2002.

³Employee Ownership Report, May/June 2003, NCEO, page 12.

⁴How an Employee Stock Ownership Plan Works, NCEO, 2002.

⁵Employee Ownership Report, January/February 2003, page 15.

⁶Ibid.

⁷Ibid.

NEWSFLASH

August 13th-14th - Huntington Beach

CRA Legal Issues Symposium

Thomas Pastore presented "Pre-Condemnation Damages and Inverse Condemnation"

Nevin Sanli presented "Acquisition and Relocation Challenges in Neighborhood Shopping Center Projects"

September 4th-7th - Anaheim

The 76th Annual Meeting - State Bar of California

SP&H was an exhibitor

September 17th - Los Angeles

The Los Angeles Venture Association (LAVA) -

Valuation for Financing or Selling the Company

SP&H sponsored and Nevin Sanli presented "Valuation for Financing or Selling the Company"

September 18th - Sacramento

The Appraisal Institute, Sacramento Sierra Chapter

and The International Right of Way (IRWA), Chapter 27

Forrest Vickery presented "Goodwill Loss for Eminent Domain"

September 24th-25th - Beverly Hills

2003 Association for Corporate Growth (ACG) -

Middle Market Conference: Mergers, Acquisition and Finance

SP&H was a sponsor

October 23rd - San Francisco

CLE Eminent Domain Conference

Thomas Pastore and Forrest Vickery will be presenting "Goodwill Loss in California"

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An Evening of Appreciation
on November 19, 2003
to express our thanks and appreciation to our clients, our community, and everyone within the family of SP&H.

In addition we are proud to feature
Girls Incorporated of Los Angeles
a non-profit organization

To broaden their presence in our community and raise funds for girls programs across the Los Angeles area.

Please contact Tracy Washburn for questions or to make a donation to Girls Incorporated at 310/571-3400.

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