Employee Stock Ownership Plans

Rewarding Your Key Executives While Addressing Capital and Shareholder Liquidity Challenges

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Introduction

- Is there such a thing as board-controlled, “friendly” capitalization?
- Can you hold and reward your key executives in the current environment?
- Is there another market for your stock, besides inside or outside investors, your competitors or the public markets?

Introduction

- Is there a way to purchase bank stock with tax-deductible dollars?
- Can a tax-deductible private stock market purchase stock with less dilution to existing shareholders than that from investment capital?
- Can Tier 1 capital be created with tax-deductible earnings and acceptable dilution?

Overview of Today's Presentation

- » ESOP Basics
- » Benefit to Key Executives and Management
- » ESOP Pros and Cons
- » ESOP Structures
- » Valuation Issues
- » Q & A

ESOP Basics

» ESOPs are a qualified retirement plan under IRC Section 401(a) mandated to invest primarily in employer securities (bank holding company shares)

» ESOPs must own the highest and best class of employer securities with respect to voting, dividend and liquidation rights

- Coincides with regulators' desire to see common equity ownership

» Employees are not the stock owners

» The legal owners of the stock are the Trustees

ESOP Basics

- ESOP shares are voted in most instances by the Trustees
  - Vote passes through for closely-held bank ESOP participants in limited cases
  - Public company ESOP vote passes through to participants in all cases subject to shareholder vote
- ESOPs can borrow money to buy stock with deductible P+I payments
- Level of ESOP stock ownership is subject to Bank Change of Control Act; Reg. W may also come into play

ESOP Employee Benefit

» Unless already in existence, TARP banks are not allowed to utilize traditional deferred compensation arrangements such as incentive stock options or SERPS to reward key executives and managers. However, management employees may participate in an ESOP and receive allocations of bank stock in a trust

- Cash contributions to the ESOP are tax deductible and used to either release shares to the accounts of employees in a leveraged ESOP or purchase fresh shares of the bank in a cash for shares transaction
- The contribution is a retirement benefit not taxed to the employee until it is distributed at a later date as a result of a distributable event (death, disability, retirement, or termination of service)

ESOP Employee Benefit

» Incentive as an employee benefit

- Management is incented to grow bank value
- Can be coordinated with stock contributions to the ESOP

ESOP Benefits

- Stock and/or cash contributions are tax-deductible to the sponsoring company
- ESOP contributions may be used, when approved by the Plan Trustees, to purchase shares from the company and its shareholders

ESOP Benefits

» Enhances ability to build and/or maintain capital

- Capital is mission critical for banks
- Conventional sources of capital

After-tax earnings

- ESOP bank has potential tax savings
  - ESOP bank's Tier 1 capital can be improved with pre-tax dollars
  - Allows for either a faster build-up or a higher level of capitalization

Outside investors

- ESOP provides certain advantages relative to raising external capital
  - Ability to improve capital while maintaining control
  - Possibly less dilution of shareholder value using ESOP

ESOP Benefits
Impact of ESOP on Capitalization

	Bank Today		**Well Capitalized Ratios**
	Total Common Equity Capital	30,000	
	Less unrealized gains	(2,000)	
A	Tier 1 Capital	28,000	
	Allowable ALLL	3,500	
B	Total Capital	31,500	
C	Leverage Assets	350,000	
D	Risk weighted assets	280,000	
A / C	Leverage Ratio	8.00%	**5.0%**
A / D	Tier 1 Risk Weighted Ratio	10.00%	**6.0%**
B / D	Total Risk Weighted Ratio	11.25%	**10.0%**

	Assumptions	
E	Net Income (without ESOP)	2,000
F	Net Income (with ESOP)	1,400
G	Pre-Tax ESOP Contribution	1,000

Ratios without ESOP		**Calculation**
Leverage Ratio	8.57%	**(A + E) / C**
Tier 1 Risk Weighted	10.71%	**(A + E) / D**
Total Risk Weighted	**11.96%**	**(B + E) / D**
FUNDING PHASE		
Ratios with ESOP		
Leverage Ratio	8.40%	**(A + F) / C**
Tier 1 Risk Weighted	10.50%	**(A + F) / D**
Total Risk Weighted	**11.75%**	**(B + F) / D**
AFTER STOCK SALE TO ESOP		
Ratios with ESOP		
Leverage Ratio	8.69%	**(A + F + G) / C**
Tier 1 Risk Weighted	10.86%	**(A + F + G) / D**
Total Risk Weighted	**12.11%**	**(B + F + G) / D**

ESOP Benefits

- ESOP has certain benefits relative to raising external capital
  - Potential for better pricing
    - In 2010 and 2011, a majority of transactions to raise capital occurred at discounts from the last trading price prior to the announcement (average of approximately 10% to 15%)
    - Could see further pricing decline from a surge in demand as more banks attempt to attract outside investors
      - Would create a buyers' market
      - May further reduce prices for sellers and increase shareholder dilution
    - Loss of value to current shareholders

ESOP Benefits

» ESOP has certain benefits relative to raising external capital

- Maintain control
  - » Control and/or other restrictions are often demanded by outside investor groups when used to raise capital
- Shareholders could suffer less dilution
  - » If stock is acquired by the ESOP over time, improved cash flows may result in better retained earnings
  - » ESOPs stock contributions provide a tax-deduction for the non-cash item (much like depreciation) without loss of control

ESOP Benefits

» Provide an employee benefit

- Benefit is tied to long-term stock performance

» Create an internal stock market

- ESOP provides an additional source of liquidity for investors
- Transaction activity promotes confidence in stock pricing

ESOP Stock Contributions

- Non-deductible expenses can often be converted to a deductible one at the price of some dilution, and occasionally by recasting cash profit sharing retirement contributions as ESOP stock contributions
- Another mechanism includes the issuance of new shares to an ESOP having a value equivalent to the cost of paying down TARP or SBLF obligations

Benefits for TARP Banks

- Banks using TARP preferred stock face the following challenges
  - Paying escalating after-tax dividends over time
  - Ultimately redeeming the TARP preferred stock with after-tax dollars
  - Bringing in outside investment capital
    - Outside investors may exact a high price in terms of shareholder dilution
- A minority-interest ESOP is not governed by TARP regulations
- An ESOP can provide a potential source to repay TARP obligations through tax-deductible contributions used or accumulated to purchase stock

ESOP Negatives

» Repurchase Obligation

- Stock in the ESOP must ultimately be repurchased by the sponsoring corporation or the plan
- Represents a long-term, emerging obligation
- While the obligation is typically not booked on the balance sheet and does not impair capital, it is a real obligation and will require funding
- Can be managed using prudent funding and key executive plans

» Fiduciary Roles

- Directors and ESOP trustee(s) are fiduciaries
- Personally liable for operating the plan for the exclusive benefit of the plan participants
- Care must be taken to document the fiduciary prudence and carry the appropriate fiduciary liability insurance for both the BOD and Trustee(s)

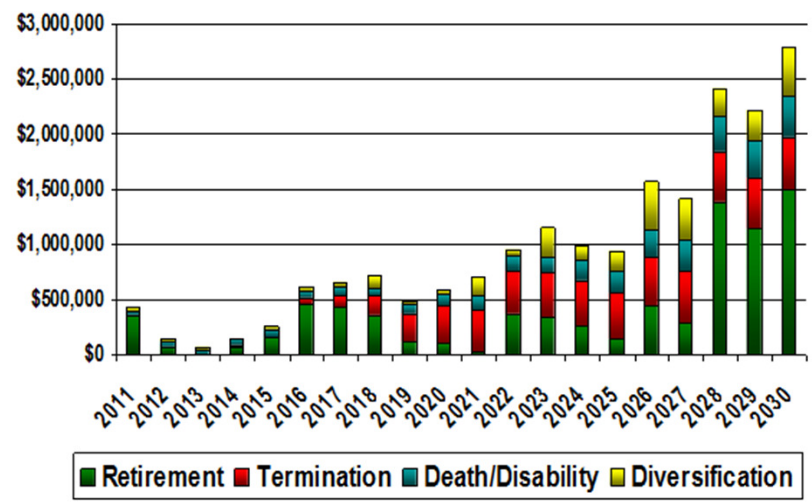
» Complexities

- Added requirement to understand stock flow management

ESOP Negatives

» Repurchase obligation

- ESOP participants generally receive cash (not stock) for their vested retirement plan payouts
- Can be managed using prudent funding and key executive plans



ESOP "Real World" Example

» Small community single bank holding company

- Holds TARP
- C-corporation
- 49 fulltime employees
- Eligible compensation for retirement contribution purposes is $2.0 million
- Key executives with $100,000 in compensation and greater received 47.06% of the employer stock and cash retirement contributions each year while the rank and file employees received 52.94%
- Executive employee contributions are unaffected by TARP limitations

STRUCTURES

Additional Considerations for TARP Banks

- Begin creating some of the requisite liquidity with discretionary, tax-deductible contributions to the ESOP accumulating untaxed dollars for future stock purchase
- Deductible contributions must not impair capital
- Measure actuarial profile of current and probable future plan participants
  - Design the ESOP provisions for minimal payouts in early cash accumulation years

Additional Considerations for TARP Banks

- Possible strategies
  - Recapitalize TARP preferred shares as voting stock appropriate for an ESOP
    - Some leverage may be available and consideration should be given to a convertible preferred security
  - Use accumulated untaxed cash in ESOP to "go public" internally
    - A later sale of newly issued shares to the ESOP restores the cash to the holding company's balance sheet, which then uses it to buy out the TARP preferred security

STRUCTURES

Simple Annual Tax-Deductible Stock Contributions

The corporation receives a tax-deduction for the value of the newly issued shares contributed to the ESOP.

The contributions are discretionary each year and deductible, if within IRC 404 limits and paid by the filing of the corporate returns.

C Corporation

Annual Tax-Deductible Contributions; 25% of Pay Limit

Possible Deductible Dividends Paid on ESOP Shares with Dividend Paying Security

ESOP Tax-Exempt Employee Trust Retirement Plan

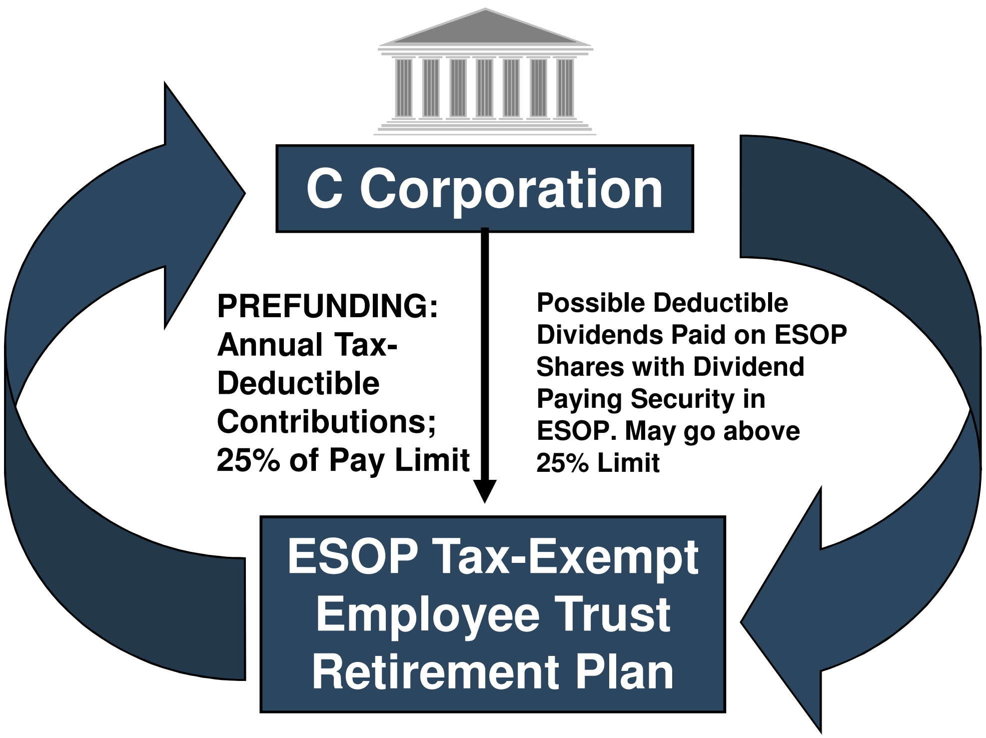
Participating Employee Stock Accounts
Long-Term Emerging Non-GAAP Obligation

Real World Example: The corporation has $1.6 M of pre-tax earnings. Its normal after-tax cash flow for capital accumulation or dividend payments would be $1 M. With a payroll of $2M and a 25% of pay contribution to the ESOP in new shares, the $500K tax- deduction (a dilutive event) would increase the cash flow/capital to $1.2 Million.

STRUCTURES

Sale of Newly Issued Shares to Pre-Funded ESOP

The corporation receives the value of the shares tax-free from the capital stock sale.



The corporation issues and sells new shares to the ESOP.

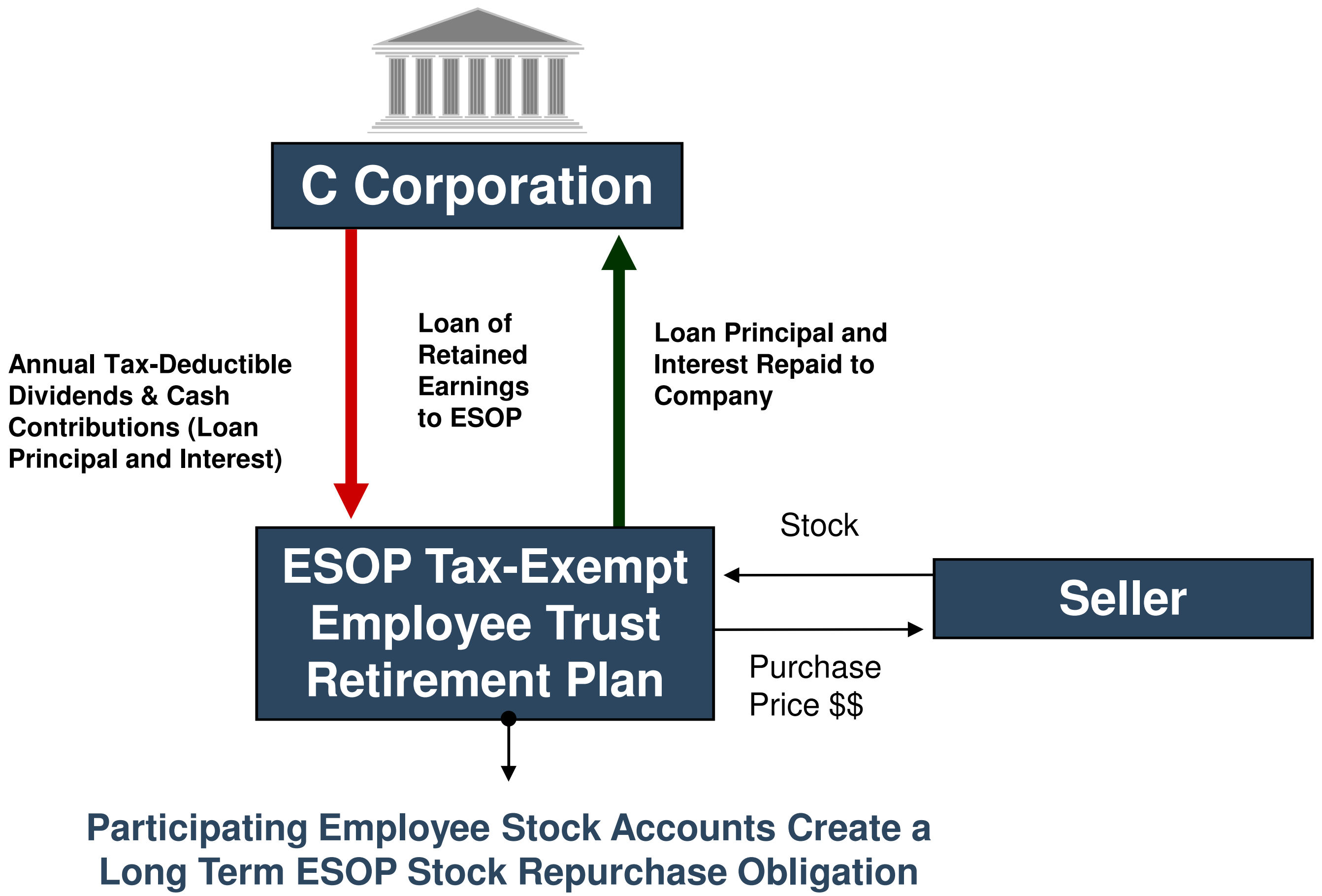
Participating Employee Stock Accounts
Long-Term Emerging Non-GAAP Obligation

STRUCTURES

Stock Purchase with Holding Company Financing

This is the only type of ESOP loan which does not require an outside lender for the transaction; however the after-tax retained earnings must be accumulated first.

The corporation repays the loan to itself with tax-deductible dollars.



VALUATION ISSUES

Parties Involved in Implementation

- Trustee
- Administrator
- Plan Sponsor
- Administrative Committee
- Attorney or Plan Designer
- Fund Manager
- Financial Advisor
- Appraiser

VALUATION ISSUES

Role of a Financial Advisor

» Financial advisor can assist fiduciary

- Employee Retirement Security Act of 1975 (ERISA) requires that shares held by ESOP be appraised by an independent third party
- Initial valuation for purchase/issuance of ESOP shares
- Annual valuation for plan administration purposes
- Periodic valuations for subsequent transactions

VALUATION ISSUES

Role of a Financial Advisor

» Transaction Role

- Analyze impact of proposed transaction on bank and ESOP
- Assist fiduciary in negotiation and structuring
- Provide fairness option
  - » Analyze whether transaction is fair, from a financial point of view, to the ESOP

VALUATION ISSUES

Regulatory Guidance

- Primary regulator of ESOPs is the Department of Labor (DOL)
  - Authority drawn from ERISA
- Secondarily Internal Revenue Service has authority to review activities of plan
- Depending upon trading volume, there are specific rules issued by the DOL & IRS to govern the valuation process for ESOP shares
- ESOP and valuation community have taken steps to define standards of appraisal practice

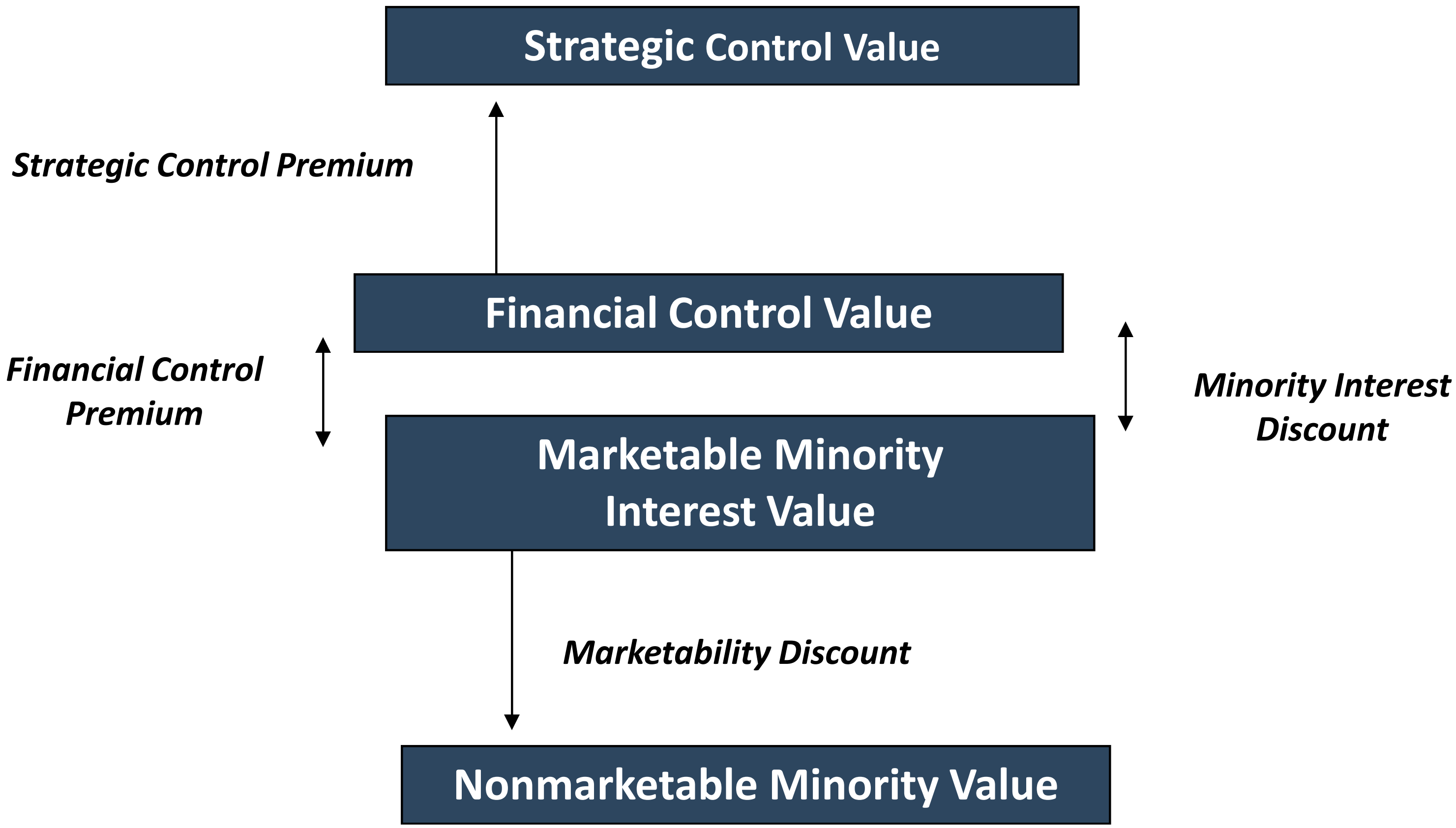
VALUATION ISSUES
Regulatory Guidance

- Adequate Consideration
  - DOL has proposed that ESOP must pay no more than "adequate consideration" when buying ESOP shares and sell for no less than "adequate consideration" when disposing of employer stock
- IRS Revenue Ruling 59-60
- Fair Market Value
  - *The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms' length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of relevant facts*

Source: ASA BV Standards (November 2009)

VALUATION ISSUES

Levels of Value



VALUATION ISSUES

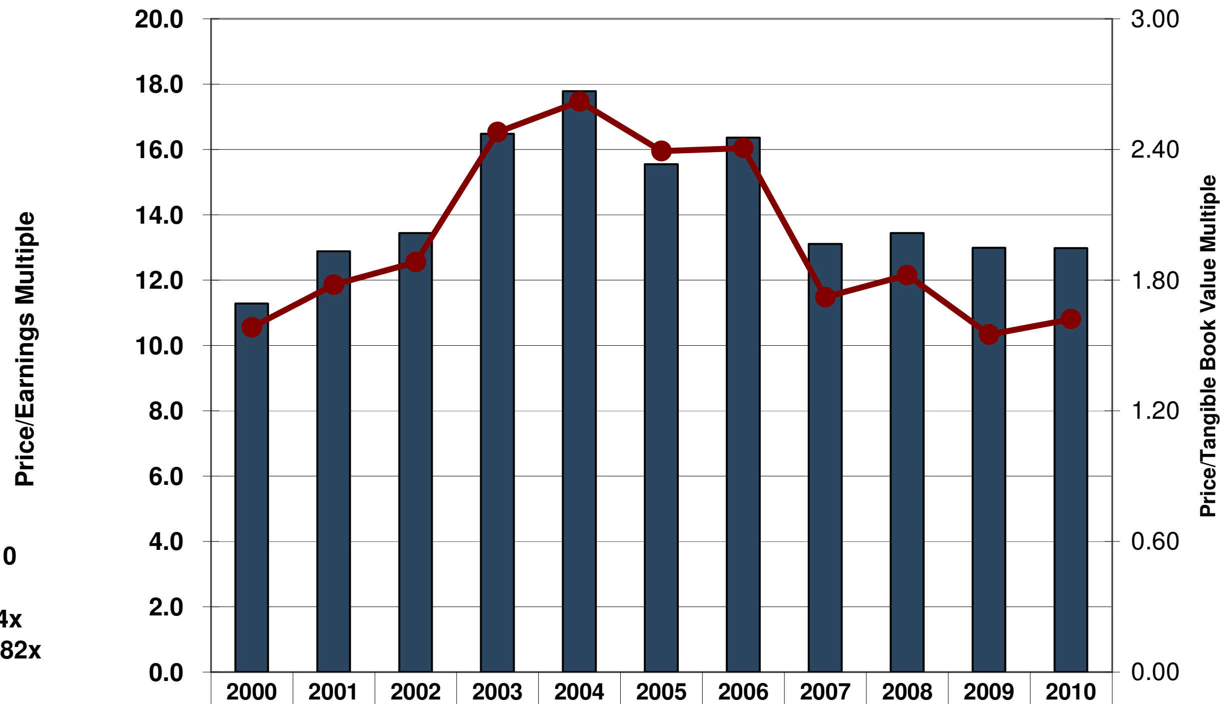
Valuation Approaches

- *American Society of Appraisers* recognizes three general approaches to valuation. Within each approach, there are a variety of methods that appraisers use to determine value
  - ***Asset Approach***
    - *"… a general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities."*
    - Methods include: Net Asset Value
  - ***Income Approach***
    - *"… a general way of determining a value indication of a business, business ownership interest, or security by using one or more methods through which anticipated benefits are converted into value."*
    - Methods include: Discounted Future Benefits
  - ***Market Approach***
    - *"… a general way of determining a value indication of a business, business ownership interest or security by using one or more methods that compare the subject to similar businesses, business ownership interest, securities, or intangible assets that have been sold."*
    - Methods include: Transactions, Guideline Public Company, and Merger and Acquisition

VALUATION ISSUES

Market Trends

Price/Earnings and Price/Book Value Multiples
Banks with Assets of $500 million - $5 Billion & Return on Tang. Equity > 10%



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Price / Earnings	11.3	12.9	13.4	16.5	17.8	15.6	16.4	13.1	13.4	13.0	13.0
Price / Tang. Book Value	1.58	1.78	1.88	2.48	2.62	2.39	2.41	1.72	1.82	1.55	1.62

2000 - 2010
Medians:
P/E: 13.44x
P/TBV: 1.82x

VALUATION ISSUES

Marketability Discounts

- ESOP plan documents typically have a “put” provision that is legally enforceable and financially viable
- Put clause allows the participant to put the stock to the sponsoring employer first, to the plan, or both
  - Reduces marketability discounts on ESOP shares
- Discounts are frequently in the 5% to 15% range for ESOP shares
- Discount for ESOP shares can be different from those shares outside of the plan
  - Often discounts are higher for shares outside plan

Questions

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