Real World Sustainability

A Quarter Century of Adaptive ESOP Strategies

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NEW RIVER ELECTRICAL

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NEW RIVER ELECTRICAL

Today's Take-Aways:

- **Learning from the experience of others**
- **What works**
- **What doesn't**
- **And why coordinated strategies are critical**

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NEW RIVER ELECTRICAL

- The History
- The Numbers
- The Challenges
- The Strategies Adopted
- The Flexibility for the Future

New River Electrical Corporation

- Founded May 27, 1953.
- ESOP implemented in 1984.
- Multi-State Electrical Contractor: Engaged principally in utility and industrial work. No commercial or residential contracting.
- All field personnel are unionized.

The NREC ESOP

Why ESOP?

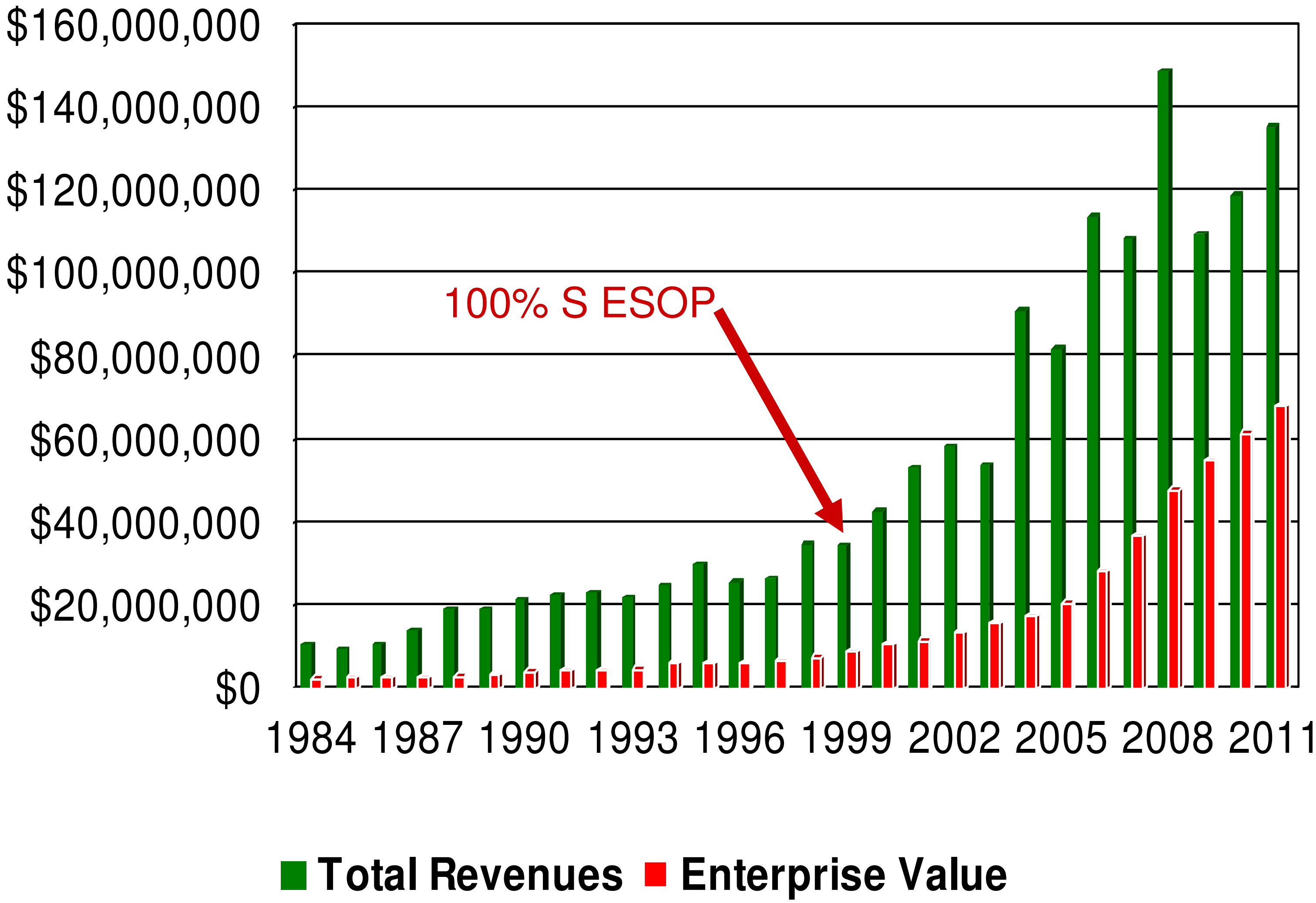
- Owners retiring at different times
- Market for shares
- ESOP 1042 tax-deferral (capital gains taxes were higher)
- Business continuity
- Retain corporate culture as locally owned & operated company

The ESOP Basics

- Participants are a mix of union (field supervisors) and non-union employees
- With a large number of small jobs in several states – needed supervisor buy-in
- Allocations based on years of service and compensation
- ESOP owned 85% just prior to S Election and 100% ownership on 1/1/1999

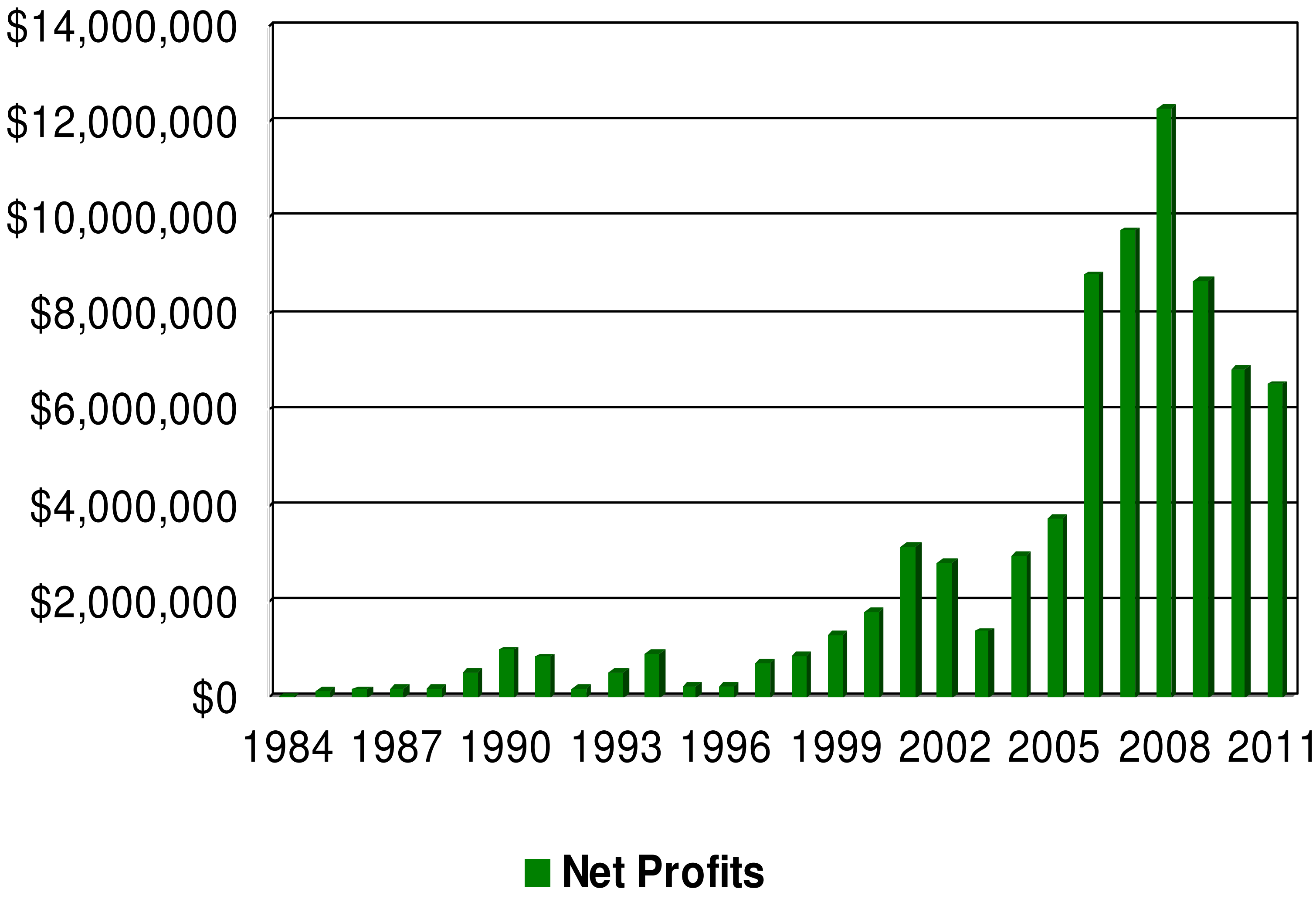
The Numbers

Can I Have This Problem, Please?



What About Net Profits…….?

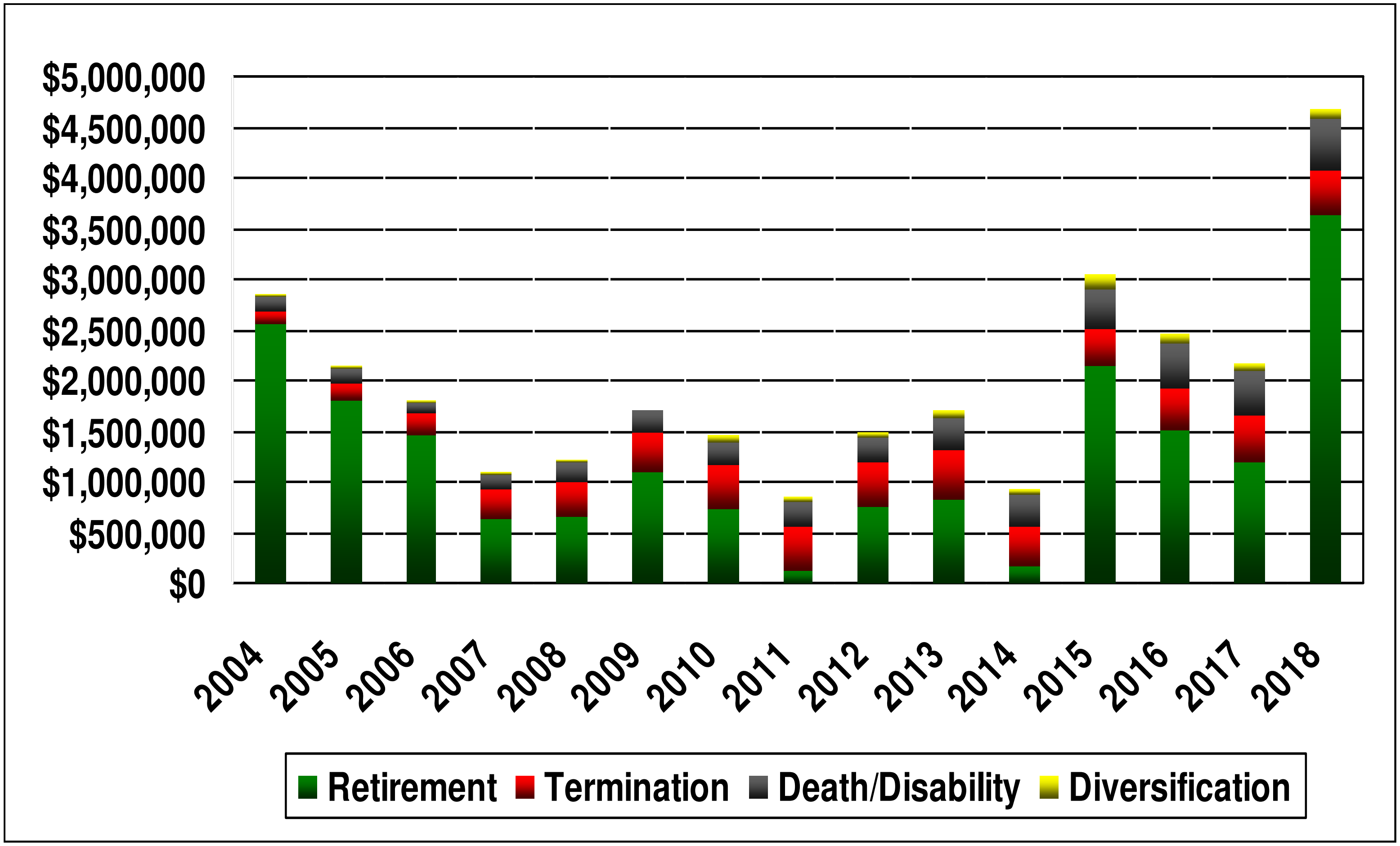
Since 1999, Tax Savings of $31 Million



But What About The Resulting Stock Buyback Liability?

1. As with most ESOP companies, it wasn't a big concern in the early years
2. Not that much stock was allocated
3. Share price appreciation for the first decade of the plan was about 6% annually (before it took off in the late 1990's)
4. The two major drivers of the obligation are price appreciation and <u>distribution rules</u>

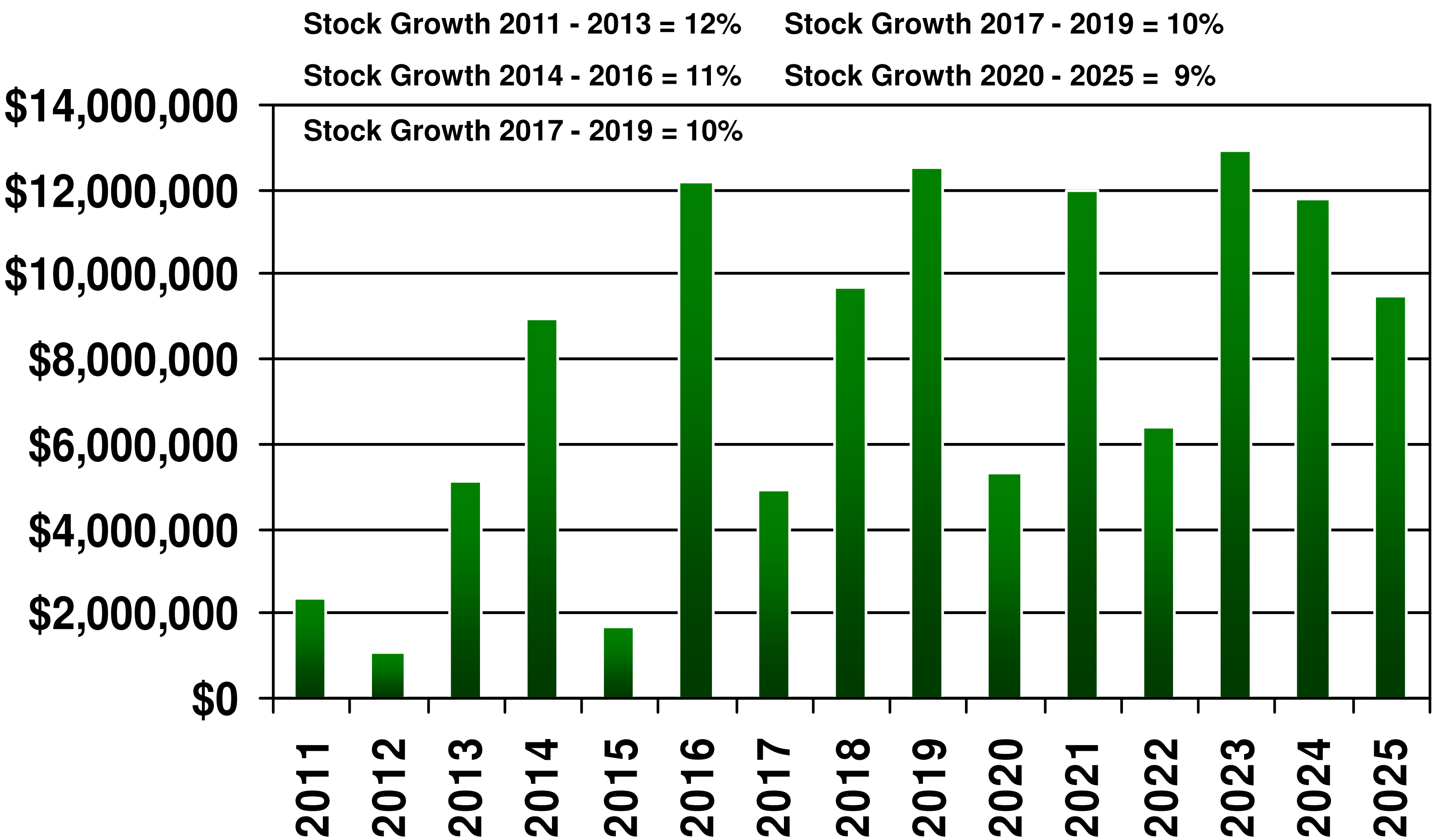
The Obligation Grew:
An Early Repurchase Study from 2003 for 7% Price Appreciation



Cumulative Obligation of $29 Million over 15 Years

And Grew and Grew…

The Most Recent Projections for Lump Sum Distributions, No Delay



Cumulative Obligation of $116 Million over 15 Years: Fast Rate of Share Recycling Through ESOP

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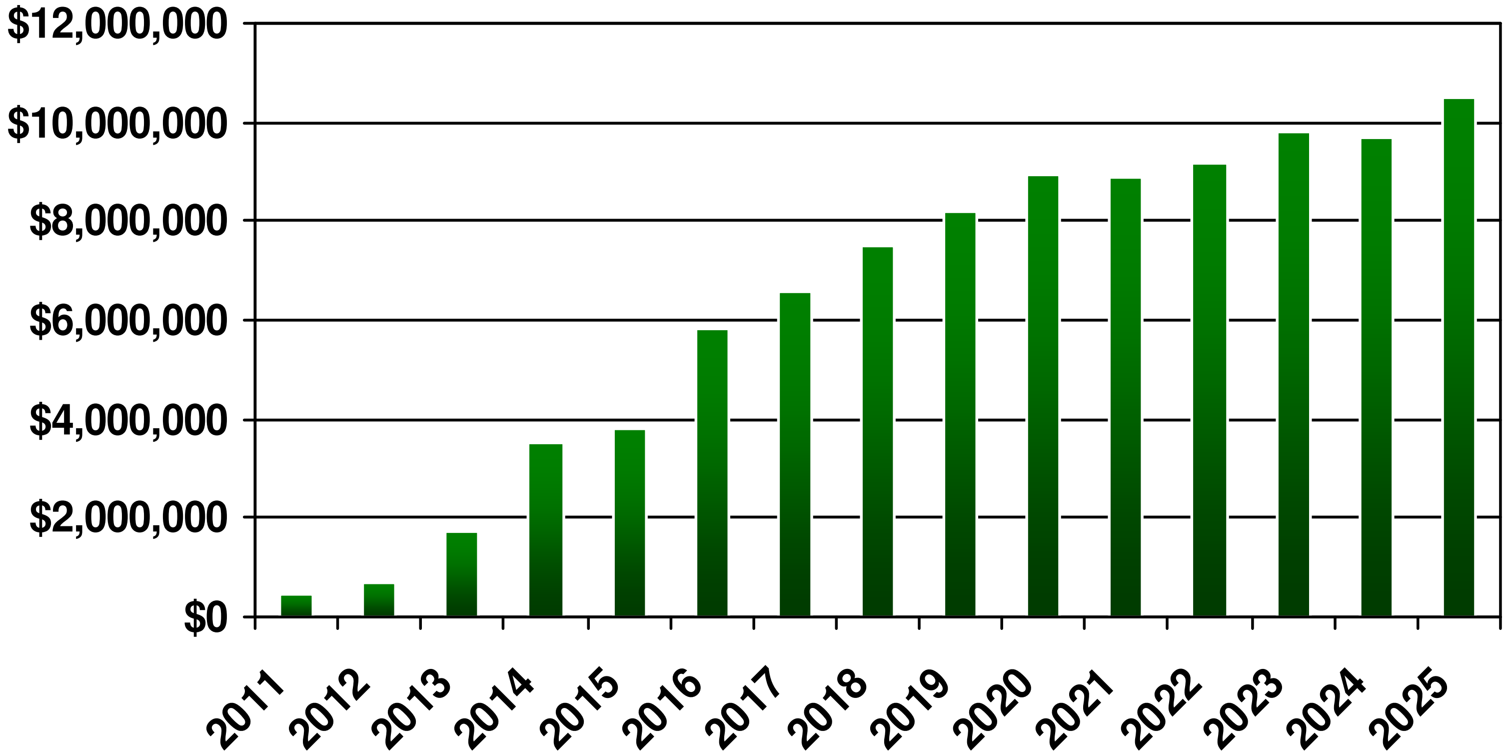
The Stock Buyback Liability
What Could Be Done: Smoothing the Curve

The same assumptions as before, but payouts made in five installments (let's see why NREC doesn't do this):



Cumulative Obligation of $95 Million over 15 Years: Slower Rate of Share Recycling Through ESOP.

What Repurchase Strategies and Why?

- NREC needed to deal with the intrinsic competition for capital between the retirement stock plan and the need to grow the company.
- How could the mature ESOP be made to better resemble the start-up ESOP?
- What level and type of repurchase funding was appropriate?
- What role do participant expectations play in these decisions?
- How has the company done at managing expectations in a mixed union and non-union environment?

What Has Been Done to Date

1. Purchased professional software to update repurchase studies internally.
2. Fully-funded COLI: $3 M cash value; $10 M death benefit.
3. Sequestered account on balance sheet – dollar cost averaging $250K monthly into market.
4. Adopted flexible strategies for management of both cash and stock flows. Allows for both corporate redemptions and recycling of shares in the plan.
5. Key component in high stock appreciation years with large buybacks is the new issue of shares releveraged into plan. Shares go to suspense account and are allocated over 10 years in line with "company to ESOP" loan repayment (5 loans in place now).

Technique for Releveraging Shares into the ESOP

Typically Loans Run 10 Years with Principal-Only Release Formula

Smoothing the Buybacks and Finding Shares for New Participants

Unlike contributions of cash or dilutive, newly issued shares, these transactions are true stock purchases and must be effected prior to the year end in which the reallocation is to start. Thus an appraisal update at the time of purchase and a true closing are required.

NREC
Subchapter S Corporation

Redeemed Shares Resold to Plan

Note from ESOP to Company with payments from annual contributions

Shares from Repurchased Accounts

Employee Stock Ownership Trust
Tax-Exempt Single Shareholder

Pro-Rata Share of S "Dividends"

Deductible ESOP Contributions

Pro-Rata Share of S "Dividends"

Active Participant Accounts

Terminee Accounts?

Designed to mimic a start-up ESOP.

Several loans over time get over 30% of the common equity into the ESOP suspense account.

COMPLIANCE!

1. How have the third party plan administrators done?
2. How well has the company management monitored the record-keeping? What happens with multiple retirement plans?
3. What did the company do to prepare for a Department of Labor audit?
4. What were the results of the Department of Labor audit?
5. The DOL is now auditing the plan auditors' work: what obligation does the company have to oversee its accountant?
6. What to document? <u>Everything.</u>
7. The Trustees should have records of meetings and conversations with the independent appraiser – among other things.
8. Fiduciary liability insurance! (Corporate indemnification of fiduciaries does not always work.)

ERISA Counsel

1. Who does counsel really represent (Company, Trustees, Administrative Committee)?
2. Keeps plan properly amended and handles timely filings with the "Service."
3. Deals directly with DOL/IRS representatives.
4. Where necessary, reviews the decisions of fiduciaries (which includes the Board of Directors and the Trustees).
5. Represents any Trustee making a stock purchase decision for the ESOP.
6. Handles the IRS corrective procedures in the event of a "glitch."

(Please keep your ESOP counsel apprised of what you are contemplating before you do it!)

Participant Expectations

- Do what you can to create a “slow-burn” ESOP with a consistent pattern of account value growth over time (not the same thing as share price appreciation). Expectations are difficult to manage on a roller-coaster.
- Communicate! NREC must deal with the difficult environment of a geographically scattered workforce.
- Emphasis on a culture of employee ownership has created a productive workplace.
- Hold at least annual employee meetings to discuss performance. NREC shows long term ESOP results, the effect of plan contributions, distributions of earnings (“dividends”) and share price appreciation.
- The third-party plan administrator provides an annual letter to participants, a website permitting projections of ESOP accounts and a summary of plan features.

Above All

1. Assemble an expert team of advisors; hold regular meetings.
2. Keep your advisors informed.
3. Cross-check their homework with others where possible.
4. Consider retaining an independent strategic consultant for the oversight role – you have a business to run.
5. Document what you do and say with a careful eye on fiduciary prudence – even if the ‘documentation’ is only contemporaneous notes of a conversation on a legal pad.
6. Stay ahead of the communications curve with your employees – especially if the news isn’t good.
7. Don’t assume the answer you heard yesterday is good today…you are, after all, dealing with the government.