Building the Balance Sheet: Competition for Capital in an ESOP Company

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Goals of the Session

- Understand the lifecycle of an ESOP.
- Be aware of the possible differences in cash flow requirements during each phase.
- Understand different strategies for addressing capital needs during each phase.
- Understand the impact of some of these strategies.
- Ask questions and engage in discussion.
- Have some FUN.

What Does Competition for Capital Mean?

- Use of capital-what should we be spending money on?
- Competing needs for capital-pros and cons of spending money on one need versus another.
- What is the timing of the impact of decisions to employ capital-when do we reap the benefits?
- What are the consequences of these decisions-are we still consistent with corporate goals?

How is the Competition for Capital Different for an ESOP Company?

- Funding for ESOP debt service.
- Funding the repurchase liability to pay terminee account balances.
- Normal operations.
- Expansion.
- Retaining key management.
- Effect of spending on value.

In order to answer what the corporate and ESOP capital needs are requires careful analysis and will depend on the life cycle of the ESOP.

Capital Requirements Will Depend on The Stage of The ESOP

- ESOP must invest in primarily in the highest class of employer securities. Not an immediate requirement.
- The competition for cash is very real taking into account operations, executive compensation and ESOP funding.
- Strategic oversight of these cash requirements is essential for sustainability and success of the Company and ESOP.

Capital Requirements Will Depend on The Stage of The ESOP

- Implementation Phase
- Aging ESOP
- Mature ESOP

Implementation Phase: Is An ESOP a Good Idea?

- **Feasibility Study**
  - **Viable ESOP Candidate**

    -Owner desires to stay locally owned and operated/some control of employee destiny

    -Willing to forego potential higher deal of strategic sale

    -Going concern

    -Stable cash flow

    -Significant payroll

    -Good second tier management

    -Employee focused corporate culture (can be developed)

Implementation Phase-Strategy

- **The strategy to evaluate the appropriate timing for funding and execution of an ESOP transaction involves a great deal of analysis including:**
  - **Financial outlook and forecast**
  - **Cash flow analysis**
  - **Bank covenants**
    - **Fixed asset requirements**
    - **Working capital considerations**
  - **Bank/Surety bonding requirements**
  - **Evaluation of financing strategies/blend of strategies**
    - **Bank loan/seller notes/loan from the Company or a combination**

Implementation Phase-Strategy

- Other considerations:
  - Shareholder expectations
  - Targeted employee benefit levels
  - Long term goals of selling shareholders
  - Corporate culture-level of employee communication and education required
  - Proper communication with all parties including, attorney, CPA and the appraiser.

Implementation Phase-Initial Appraisal

- **Initial discussions with the desired appraisal firm is essential in the planning stages before implementing an ESOP.**
  - **What approach for valuation is best suited for the company/industry?**
  - **Is an appraisal of capital assets necessary as a supplement?**
  - **Will the value for ESOP purposes be high enough for the seller to decide to move forward when contrasted with other exit strategies?**

Implementation Phase-Initial Appraisal Valuation Considerations

- Standards
- Approaches
- Discounting
- Range of Values
  - Can the company cash flow a sale at the appraised value at the desired transaction level?
    - Coordination with CFO/Party designing transaction
    - 30%?
    - 51%?
    - 100%?
- Has a Special Independent Trustee been hired to review and negotiate the deal?

Implementation Phase Different Types of ESOP Transactions/FS Impact

ESOP Transaction Structures

- Pre-Fund

  -Bank Example

  Capitalization Requirements

- Non-Leveraged Cash Purchase
- Non Leveraged Stock Contributions
- Leveraged-Bank Finance

  -Manufacturing Company Example

  Bank Covenants

- Leveraged Seller Financed

  -Construction Company

  Surety Support/Bonding Requirements

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Implementation Phase: Example #1: The Pre-Funded ESOP

Year 1

Company → **$1,000,000** → **ESOP**

Year 2

Company → **$1,000,000** → **ESOP**

Results: Corporation receives tax deductions and the ESOP accumulates $2,000,000 for a future stock purchase.

The Pre-Funded ESOP *(cont.)*

- **How Would ESOP cash warehouse contributions work assuming a payroll sufficient to support a $1,000,000 contribution?**

Current No ESOP	
Pre-Tax Income:	$3,216,000
ESOP Cont.	$(0)
Taxable Income	$3,216,000
Net Taxes & Adj.	$(1,163,000)
Net After Tax Inc.	$2,053,000

Current W/ ESOP	
Pre-Tax Income	$3,216,000
ESOP Cont.	$(1,000,000)
Taxable Income	$2,216,000
Net Taxes & Adj.	$ (801,000)
Net After Tax Inc.	$1,415,000

The Pre-Funded ESOP *(cont.)*

Bank Example Key Questions:

- **How does this impact the capital and leverage ratios?**
- **How does this affect the stock value?**
- **How will investors/outside shareholders view higher employee benefits and lower earnings?**

Capitalization During Funding Phase

- **While the 20% of pay or $1M ESOP contribution may be possible….what is the impact of $2.05M vs. $1.41M net income?**

The Pre-Funded ESOP *(cont.)*

Bank Ratios No ESOP		**Ratios with ESOP**	
Total common equity capital	$28,957	Total common equity capital	$27,957
Less unrealized gains	(1,232)	Less unrealized gains	(1,232)
Tier Capital	27,725	Tier Capital	26,725
Allowable ALLL	3,401	Allowable ALLL	3,401
Total capital	$31,126	Total capital	$30,126
Leverage assets	342,318	Leverage assets	341,318
Risk weighted assets	272,036	Risk weighted assets	271,036
Leverage ratio	8.10	Leverage ratio	7.83
Tier 1 weighted ratio	10.19	Tier 1 weighted ratio	9.86
Total risk weighted ratio	11.44	Total risk weighted ratio	11.11

ESOP Example #2 Non Leveraged Cash Purchase

Company → $2,000,000 → ESOP

ESOP → $2,000,000 → Selling Shareholder

Selling Shareholder → Company Stock → ESOP

ESOP Example #3 Non Leveraged Stock Contribution

-Company issues newly issued shares to the ESOP on a fully diluted basis

-Tax deductible

-Increases cash flow

-Dilutive to shareholders

Company → Company Stock → ESOP

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Non Leveraged Stock Contribution *(cont.)*

Stock Contribution Increases Cash Flow by $300,000

	Cash Contribution	Stock Contribution
Earnings Pre-Tax	$500,000	$500,000
Plan Contribution	(300,000)	(300,000)
Adj. Pre-Tax Earnings	200,000	200,000
Federal & State Taxes 44%	(88,000)	(88,000)
After Tax Income	112,000	112,000
Plus Non-Cash Contribution	0	300,000
Cash Flow	$112,000	$412,000

ESOP Transaction Example #4; Bank Financed Leveraged Purchase "Mirror Loans"

Bank Loan
"Outside Loan"
$4,000,000

Company

ESOP Loan
"Inside Loan"
$4,000,000

ESOP

$4,000,000

Company Stock

Selling Shareholder

Bank Financed Leveraged ESOP *(cont.)* Loan Payments

Bank Loan Payment
"Outside Loan" $400,000

Contribution/Dividend
$400,000

Company

ESOP

ESOP Loan payment
"Inside Loan" $400,000

Bank Financed Leveraged ESOP (*cont.)*

Manufacturing Company Example Key Questions:

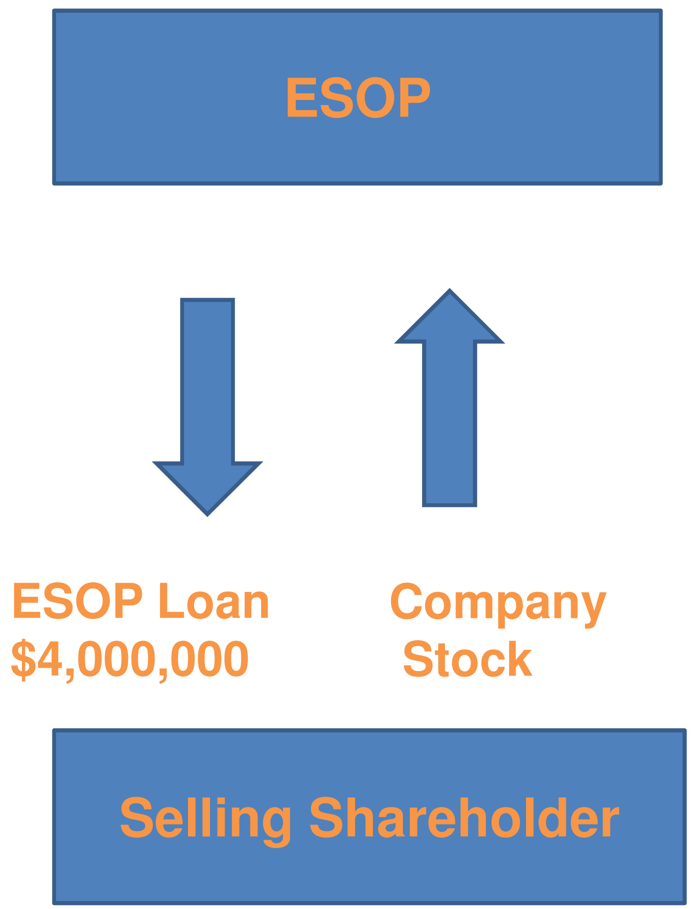
- **-How does this impact covenant ratios for existing senior debt?**
- **-Do the terms on the outside bank loan have to mirror the inside loan to the ESOP?**
- **-How does this affect the stock value?**
- **How will investors/outside shareholders view higher employee benefits and lower earnings?**
- **Cash flow; does the backlog/gross profit support Gen/Admin and the ESOP debt service?**

Bank Financed Leveraged ESOP (cont.)

Bank Financed Leveraged ESOP (cont.)

Manufacturing Co. No ESOP		Manufacturing Co. with ESOP	
Senior Funded Debt/EBITDA	.70	Senior Funded Debt/EBITDA	2.38
Total Funded Debt/EBITDA	.92	Total Funded Debt/EBITDA	2.44
Minimum Assets Coverage	1.36	Minimum Assets Coverage	.51
Current Ratio	1.67	Current Ratio	1.46
% Total Equity	68.70	% Total Equity	43.28
Int. Debt/Inc. Capital	13.38	Int. Debt/Inc. Capital	36.71
Total Liab./Equity	.5	Total Liab./Equity	1.31

ESOP Transaction Example #5; Seller Financed Leveraged Purchase



Implementation or Second Tranche Phase: Seller Financed Leveraged Purchase

Construction Company Example Key Questions:

-How does this impact the net worth ratio and analyzed working capital?

-How does this impact surety bonding?

-How does this affect the stock value?

- How will investors/outside shareholders view higher employee benefits and lower earnings?
- Does the backlog/gross profit support Gen/Admin and the ESOP debt service?
- Seller subordinated to senior debt?
- Corporate guarantee on note?

Companies Sponsoring Aging ESOPs Must Revisit Their Strategy/Cash Requirements

- ESOP at 10 years must offer diversification payouts.
- Potential second/third tranche transactions to continue succession plan.
- Distributions to terminees begin to grow as the ESOP ages.
  - Mortality and morbidity payouts add up
  - Shares have been released
  - Terminees have been gone long enough to begin installment payouts.

How to Think About the Mature ESOP

ESOPs are easiest to manage at start-up:

- Vesting is typically just beginning
- Few shares are allocated
- Share price has not had time to grow; and
- No large distributions are impending.

The mature ESOP cannot do anything about the fully vested, older participants.

To cause a mature ESOP to more closely replicate its start-up counterpart, adjustments, prudent from a fiduciary standpoint, can be made over time.

How to Think About the Mature ESOP

How to Think About the Mature ESOP

- Prospective restriction of distribution rules to include a delay on starting terminee distributions and pay in installments.
  - The contrast between immediate cash payments (even if only to the plan in a segregated fund) and maximum delays can be easily be demonstrated.
  - A good repurchase liability study with mortality and morbidity assumptions included in the forecasting model is essential to evaluation of the distribution rules.
  - IRS rules and the plan document dictate the most restrictive rules allowable based on the reason for termination:
    - Death
    - Disability
    - Retirement
    - Normal Termination

How to Think About the Mature ESOP

ESOP Competition for Cash

Questions?

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