Sustainability

Strategic Management of ESOP Operation

How to Keep the Hamster Running

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Agenda for Our Conversation

1. Companies operating ESOPs are managing an unconventional "system." It has private stock in a retirement plan…you need to understand the levers of control and the ways these are used to create a successful, long-term ESOP operation.

2. An important issue is the sometime surprising way the factors affecting sustainability interact with each other.

3. We will briefly review the strategies and mechanisms available to ESOPs which can support the optimal financial and 'psychological' health of a plan.

4. The floor is open to questions at any time during our conversation. The take-aways are: a) A broader understanding of coordinated strategies, b) Knowing what questions to ask of whom, and c) Some specific rules relative to plan operation.

Some Basic Principles

1. A central consideration in motivating business owners to do an ESOP is taxes. Becoming partially or entirely tax-exempt is appealing. But…
2. A larger issue for purposes of long-term ESOP operation and stock value is the “going concern” business viability.
3. The ESOP is never the solution – but a part of a larger strategy.
4. Businesses still need to (really) reward top performers, pay bonuses & capitalize growth. ESOP retirement benefits are long term and not entirely a substitute for incentive compensation.

It's Not Nice to Fool Mother Nature

There are Laws of Financial Physics!

1. What is generally the largest expense of a successful private company?
2. Why is the average non-ESOP retirement plan contribution less than 5% of pay?
3. What is the intrinsic competition for capital in an ESOP company?
4. How should this be managed?

And just what do we do to keep the hamster happy?

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Key Concepts (Easy to Say…)

The Best and Most Sustainable ESOPs Should Generally:

1. **Have operating management with a clear and effective operating philosophy.**
2. **Operate in a ‘slow-burn’ and (hopefully) predictable mode without sudden spikes or drops in <u>account balances</u>.**
3. **Have a well-understood and (at least) partially funded ESOP buyback obligation, using cash either in the ESOP or the company.**
4. **Have distribution rules which are clear and understood by management & participants; flexibility is key.**
5. **Have advisory professionals for administration, plan compliance monitoring, valuation and other functions who <u>work together.</u>**

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A Good Place to Start Understanding Stock Flow and Cash Flow Management

The ESOP Long-Term Stock Repurchase Obligations

1. No surprise: Put stock in a retirement plan and somebody will retire. Then you get to re-buy it.

2. These can be kept quite reasonable and a real benefit to the participants – but they must be understood and proactively managed.

3. Here's what drives them (and it isn't just simply the share price)=>

Some Key Factors Affecting the Magnitude of the Obligation:

1. Company performance
2. Share price
3. Plan provisions
4. Administrative distribution rules for payouts
5. Number of shares issued and outstanding
6. Mechanism used for share purchases and repurchases (corporate redemption, recycling in the ESOP, leveraged repurchases)
7. Rate of share allocations in a leveraged ESOP
8. Rate of new share contributions

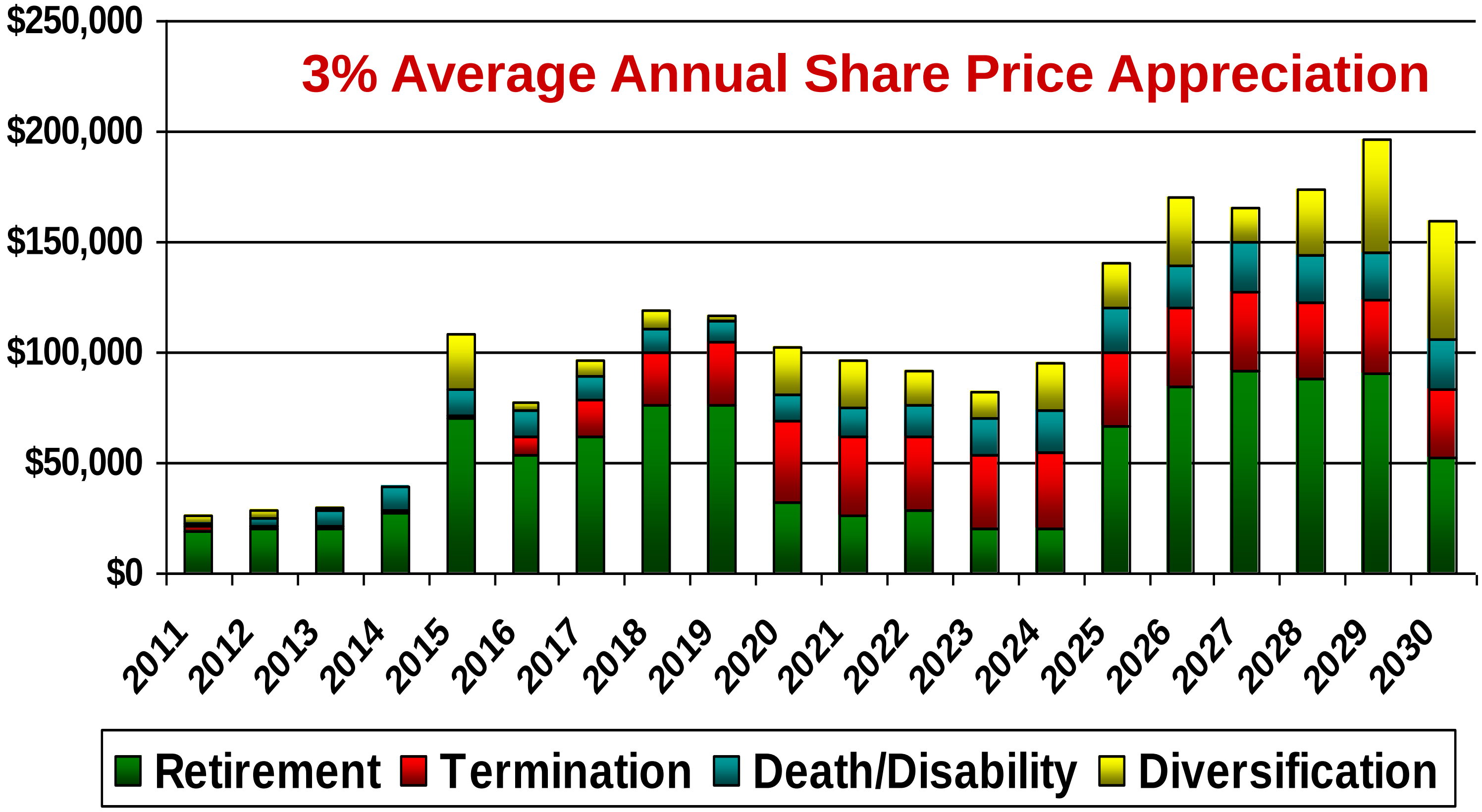
Setting the Stage: Strategies vs. Tactics

1. The follow two slides show the same company with the same share price appreciation, same actuarial statistics and same recycling of shares in the plan, with only one difference.

2. The administrative distribution rules governing payouts from the plan are very restrictive (participant accounts held in stock) in the first case.

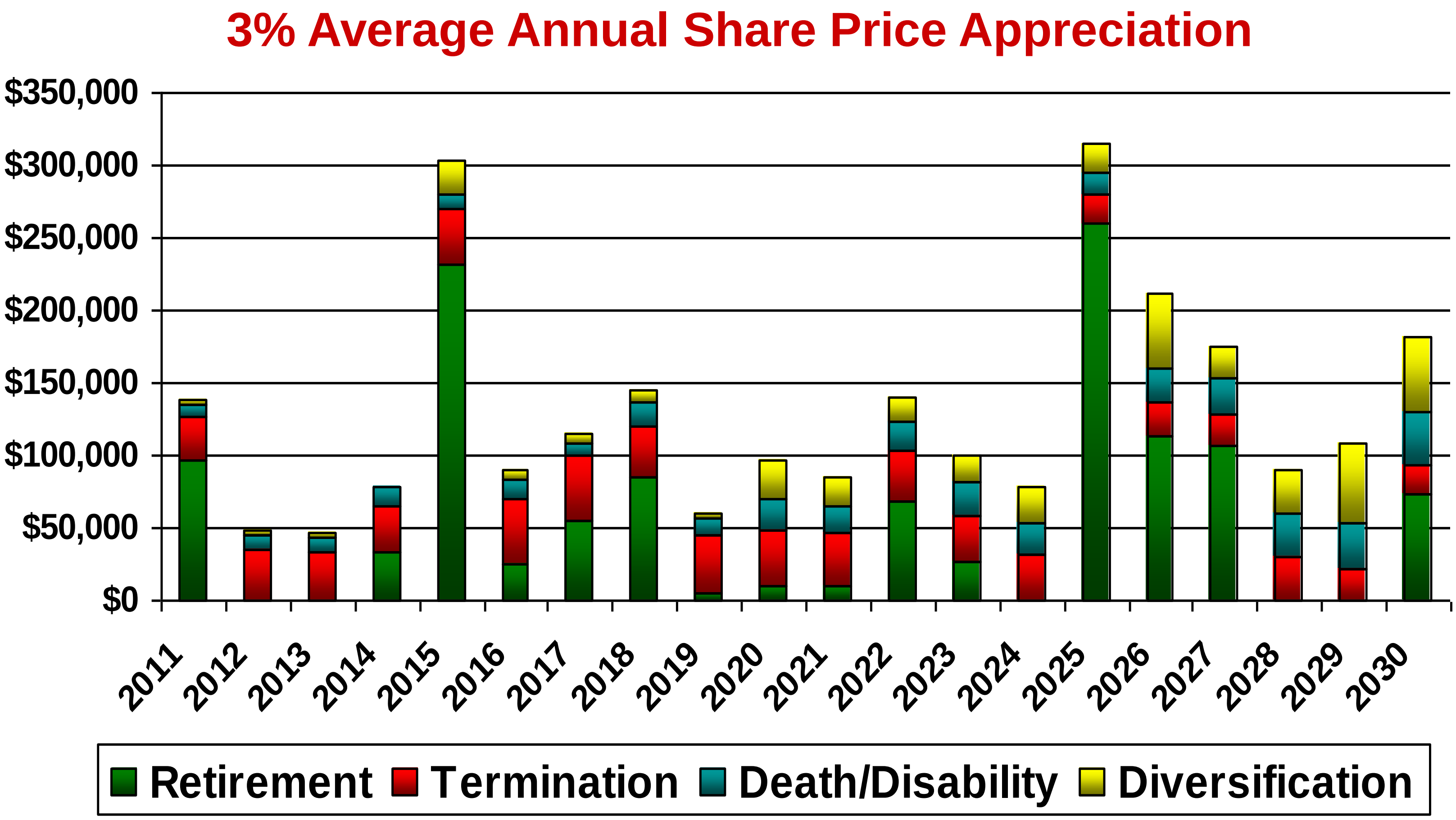
3. In the second case, all terminee accounts are converted to appropriate "Other Investment Accounts" – thus requiring immediate liquidity.

Case I: Repurchase Projections with Restrictive Distribution Rules – Delayed Payouts from Accounts Kept in Stock. Shares Recycled in Plan



Maximally Restrictive Distribution Rules

Case II: Same Company, Same Recycling, but With All Terminee Accounts Requiring Immediate Liquidity and Reallocation of the Shares from Terminee Accounts



The Price of Immediate Liquidity

What Is Happening Here? Why the Big Differences?

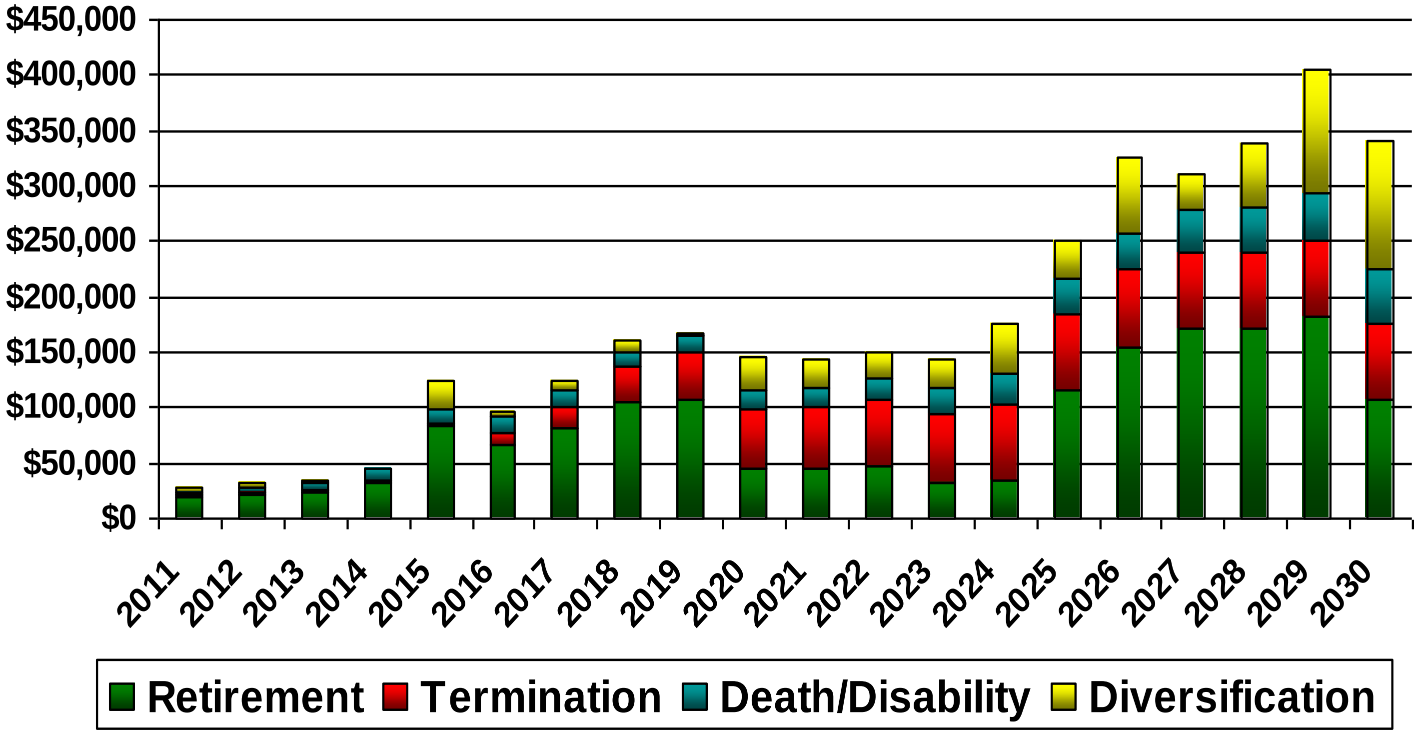
Cumulative Payouts Through Years==>	2015	2020
I. Restrictive Rules 3% Growth Baseline	$ 232,099	$ 743,530
II. Liberal Payouts 3% Growth Baseline	$ 615,155	$ 1,121,222

1. The conversion of stock to other investments means a faster reallocation of shares when stock is recycled in the plan…faster buyback of all shares.
2. This acceleration of the recycle rate can be costly and detrimental to long-term sustainability.
3. When should you have restrictive rules? Liberal rules?

Suppose The Stock Grows at 7%?

(Rapid Liquidity Can be Costlier Than High Stock Prices)

Cumulative Payouts Through Years==>	2015	2020
I. Restrictive Rules 3% Growth Baseline	$ 232,099	$ 743,530
II. Liberal Payouts 3% Growth Baseline	$ 615,155	$ 1,121,222
III. Restrictive Rules 7% Growth	$ 262,573	$ 954,552



A Cautionary Tale of a Simple System:

1. Established an ESOP in 2000, over time acquired 68% of the shares, paid off the ESOP loans and grew to have 200 employees.
2. Had no discretionary equity or equity-equivalent key executive plans external to the ESOP to offset the phenomenal growth.
3. Had a share price appreciation which amazingly averaged 40% for six of the next eight years (prosperous defense contractor).
4. Had an average participant age of 49.3, a vesting schedule which provided 100% after one year of service and immediate eligibility upon employment.
5. Had a valuation which mentioned the 'repurchase obligations,' but with no definitive projections.
6. And then, after the nice years of high earnings and share price appreciation, they saw the profits flatten out at a level which could not support the existing ESOP payout policy <u>and</u> capitalize further high levels of growth.

The Company Was Sold – A Good Outcome for Current Participants, But….

A Cautionary Tale of a Simple System

1. **All businesses go through cycles. Prudent ESOP managers will prepare to some (often small) extent to deal with a downturn.**
2. **Nothing beats some cash on the balance sheet – rarely does it make sense to accumulate excess cash in the ESOP.**
3. **Had our "simple system" accumulated some cash in the fat years, they would have had several options:**
   - **Cash on the balance sheet can be used to <u>redeem</u> shares rather than recycle shares in the plan.**
   - **This can at times have the effect of propping up the share price by the counter-dilution resulting from a smaller universe of shares.**
   - **Cash in key executive deferred compensation plans can support sustainability by incentivizing key players, supporting fiduciarily prudent price appreciation and having cash under corporate control.**
4. **Learn to manage not just cash flows<u>, but also stock flows.</u>**

What Are Some Specific Requirements for the Creation of a Sustainable ESOP?

1. The requirements differ markedly depending on where an ESOP company is on the timeline to a mature ESOP!
2. Starting ESOPs in the first few years can often accumulate untaxed cash in the plan to fund repurchase obligations or a second deal.
3. Mature ESOP companies approaching a decade or more with the plan should look to strategies that keep cash on the balance sheet.
4. Take the time and $$$ to educate your folks!
5. Document everything.
6. Measure the obligations every two or three years.
7. Try to build up a couple of years funding for the payouts.

So…what is a good way to invest repurchase funding cash and mitigate risk?

Corporate Owned Life Insurance (COLI)

A Tool for ESOP Sustainability

The Company purchases life insurance policies on selected ESOP participants

1. **Typically placed on the lives of participants with large account balances or potential for large account balances.**

2. **The company pays the premiums and is the owner and beneficiary of the policies.**

3. **Establishes an investment discipline.**

COLI – (Fixed Account) – On Balance Sheet

Advantages

1. Insures largest account balances (no medical questions if there are 10 or more participants) – enrolled like group
2. Turnover not a problem (Change of Insured)
3. Insurance company takes the investment risk
4. Reasonable IRR commensurate with risk
5. Stabilized internal rate of return
6. Once cash value asset established on the balance sheet it will not decline in value and can only go up
7. Balance sheet risk limited to interest rate risk (no mark to market) – using traditional insurance contract – portfolio based

COLI – (Fixed Account) – On Balance Sheet

Advantages

1. Long term maturity investments drive interest crediting
2. Cash buildup is unrestricted company asset - available if needed
3. Isolates cash from working capital "Earmarked" for ESOP
4. Reserve for contingencies (aggregate funding)
   - - Acquisition
   - - Tight cash flow – provides an emergency reserve for difficult times
   - - Downturn in business
   - - Credit line reduced
   - - Layoffs and unexpected repurchase
5. Shows creditors, employees, and appraisers repurchase obligation being addressed
6. Cost recovery of premiums and part or all of account balance paid out

COLI – (Fixed Account) – On Balance Sheet

Disadvantages

1. **Mortality cost of insurance (term cost)**

2. **To access cash in the early years there is an interest cost (loan against the policy-crediting rate on cash value helps offset this interest cost)**

3. **Reduction of balance sheet in early years as mortality reserves established**

Benefit Plans Funded with COLI

1. **Endorsement Split Dollar**
   - As Executive Benefit
   - For all insured employees

2. **Supplemental Executive Retirement Plan (SERP)**
   - (Ex – 40% highest 5 paid 15 years)

3. **Phantom Stock Plans**

4. **SAR Plans**

Client Corporation

ESOP Policies

	{1}	{2}	{3}	{4}	{5}	{6}	{7}	{9}	{11}
2016 Age	Death Benefit 5/18/2016	Total Cash Value 5/18/2016	Cumulative Policy Outlay 5/18/2016	2015 Payment	2015 - 2016 Cash Value Increase	2015 - 2016 Net Cash Value Increase (5) minus (4)	Cash Value Rate of Return (6) divided by (2)	Premium Rate of Return (6) divided by (3)	Death Benefit Rate of Return (3) divided by (1)
63	$ 340,087.00	$ 128,563.07	$ 107,812.50	$ 7,187.50	$ 11,885.50	$ 4,698.00	3.65%	4.36%	31.70%
68	$ 510,217.00	$ 249,322.85	$ 126,260.70	$ 8,417.38	$ 17,671.92	$ 9,254.54	3.71%	7.33%	24.75%
57	$ 277,681.00	$ 86,147.53	$ 70,268.85	$ 4,684.59	$ 8,106.08	$ 3,421.49	3.97%	4.87%	25.31%
62	$ 736,742.00	$ 281,884.21	$ 228,193.65	$ 15,212.91	$ 25,901.74	$ 10,688.83	3.79%	4.68%	30.97%
56	$ 296,995.00	$ 89,136.59	$ 72,334.20	$ 4,822.28	$ 8,405.90	$ 3,583.62	4.02%	4.95%	24.36%
72	$ 942,365.00	$ 537,937.21	$ 225,451.50	$ 15,030.10	$ 35,250.45	$ 20,220.35	3.76%	8.97%	23.92%
68	$ 732,231.00	$ 348,627.64	$ 189,493.20	$ 12,632.88	$ 25,362.46	$ 12,729.58	3.65%	6.72%	25.88%
77	$ 322,192.00	$ 217,781.01	$ 164,179.95	$ 10,945.33	$ 18,524.27	$ 7,578.94	3.48%	4.62%	50.96%
59	$ 296,282.00	$ 99,088.54	$ 82,265.70	$ 5,484.38	$ 9,332.35	$ 3,847.97	3.88%	4.68%	27.77%
57	$ 246,612.00	$ 73,993.10	$ 60,219.75	$ 4,014.65	$ 6,978.81	$ 2,964.16	4.01%	4.92%	24.42%
10 Employee Totals	**$ 4,701,404.00**	**$ 2,112,481.75**	**$ 1,326,480.00**	**$ 88,432.00**	**$ 167,419.48**	**$ 78,987.48**	**3.74%**	**5.95%**	**28.21%**
50 Employee Totals	**$ 29,158,620.00**	**$ 14,009,419.87**	**$ 8,774,547.00**	**$ 584,969.80**	**$ 1,102,493.59**	**$ 517,523.79**	**3.69%**	**5.90%**	**30.09%**

Client Company

Death Claims Paid

Employee 1	May 2007	$1,093,688.26
Employee 2	March 2009	$ 355,543,.00
Employee 3	August 2010	$ 109,023.35
Employee 4	April 2011	$1,169,620.72
Employee 5	February 2013	$1,026,472.27
Total		**$3,754,347.60**

Client Examples

Manufacturing Company

- 26 Million Dollar ESOP Transaction
- 1400 Employees
- 50 Employees Insured for RO
- 27 SERP/Endorsement Split Dollar Executive Benefit
- 900K Annual Premium

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Client Examples (continued)

Construction Company - Road & Bridge

- 400 Employees
- 22 Employees Insured for RO
- 8 Employees Insured for Split Dollar/Estate Planning, etc.
- 370K Premium - RO

Regional Property Casualty Agency

- 350 Employees
- 30 Employees Insured for RO
- 780K Premium - RO

Client Examples (continued)

Manufacturer of OEM Parts

- 500 Employees
- 36 Employees Insured for RO
- 346K Premium - RO

Manufacturer of Conveyer Systems

- 86 Employees
- 19 Employees Insured for RO
- 80K Premium

Client Examples (continued)

Defense Contractor

- 200 Employees
- 6 Employees Insured
- Section 162 Bonus on 5 Executives
- 203K Premium

Disclosure Statement

Robert C. Bye, CLU, ChFC, CEBS, AEP, does not engage in the practice of law or accounting. Anything contained herein dealing with legal, tax or accounting matters should be discussed with your legal, tax and accounting advisors.

A Couple of Helpful Diagrams

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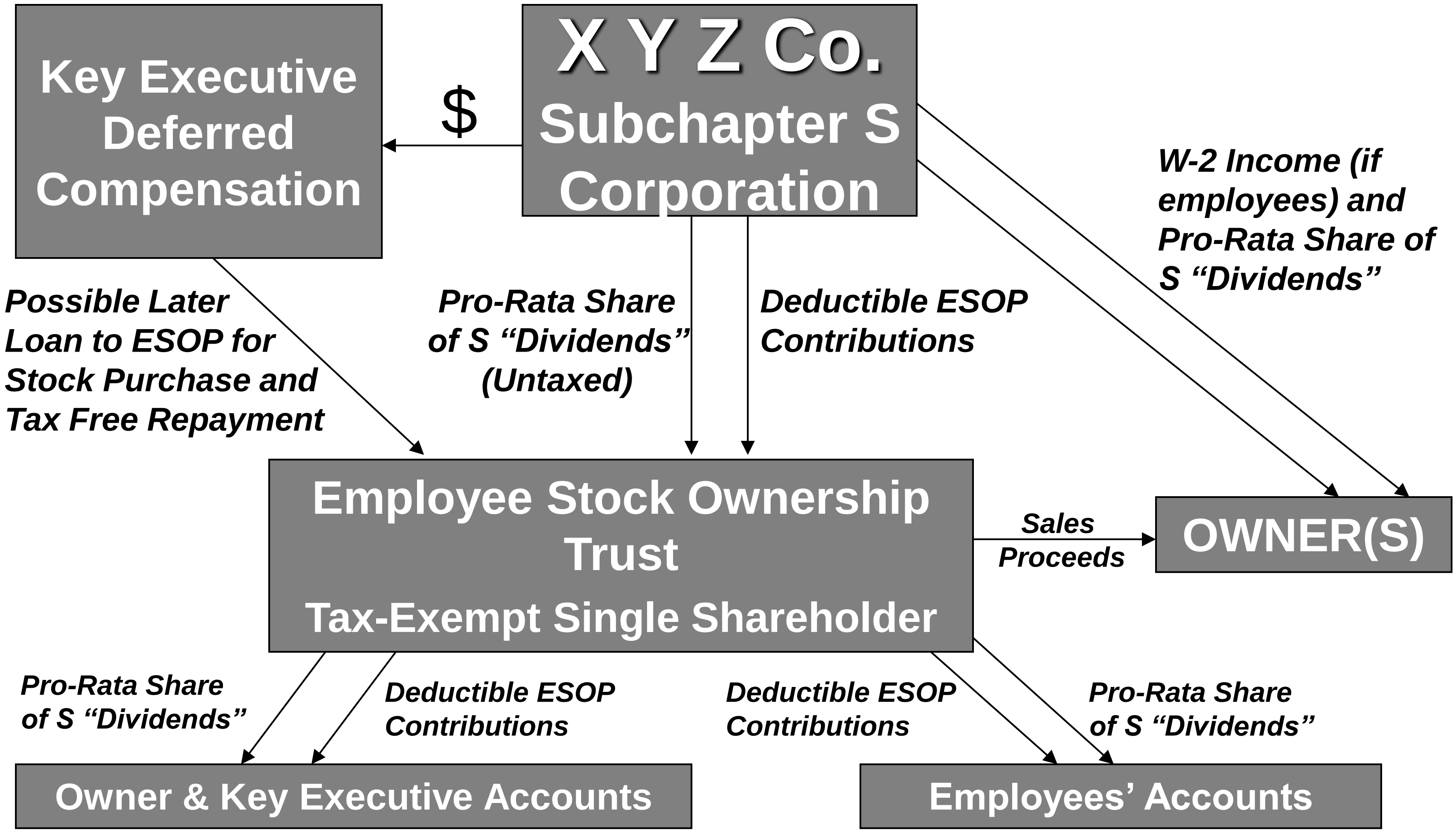
The Subchapter S ESOP

Tax Sheltered Stock Purchases + Build-Up of Key Executive Capital to Support Ownership Transition (Possible 100% Tax-Exempt Operation).



The IRS counts key executive deferred compensation as a type of ‘synthetic equity’. This is not typically an issue for well designed plans with over 30 participants. For smaller plans, both the qualified (ESOP) plan and the non-qualified plan often need careful future coordination to comply with this provision of the IRC 409(p) anti-abuse rules.

Dealing with Large Distributions – Avoiding Immediate Allocations

Technique for Releveraging Shares into the ESOP

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.

Sponsoring 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

Active Participant Accounts

Pro-Rata Share of S "Dividends"

Terminee Accounts?

Designed to mimic a start-up ESOP.

Several loans over time get considerable common equity into the ESOP suspense account.

Understanding Releveraging and Possible S Dividend Utilization

Thank You!

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