# ESOP Sustainability

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# Preface

- Please fill out a session evaluation form and drop it off at the table outside of this room
  - Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs
- Take a moment to silence your cell phone
- Remember to get your CPE sheet stamped before and after each session for CPE credit

# Why do we care if our ESOP is sustainable?

Sustainable ESOP

- Allows for choices
- Is not only for those intending to be permanent ESOP companies
- Negotiate from strength

Unsustainable ESOP

- Limits choices
- Eventually forced down a certain path
- Negotiate from weakness

Sustainability is more often than not a choice

# What makes an ESOP sustainable?

I. Leadership commitment
II. Planning
III. Accommodative business conditions

The lack of these, especially the commitment of leadership, creates an unsustainable ESOP.

# Sustainability – some definitions

- Meeting the needs of the present without compromising the ability of future generations to meet their own needs [1]
- The concept of the triple bottom line – pursuing performance in economic, social, and environmental spheres [2]
- Corporate sustainability: maintaining the corporation for the long term benefit of all stakeholders (shareholders, employees, community, etc.)
- **ESOP Sustainability: Maintaining the ability to continue the ESOP as a long term employee benefit plan and ownership model.**
- What's your definition?

*United Nations General Assembly (1987): Report of the World Commission on Environment and Development: Our Common Future . Deloitte. Sustainability in business today: A cross-industry view.*

# Why do ESOPs terminate?

1. Company receives an offer and is acquired
2. Performing financially but impacted by repurchase obligation
3. Dissatisfied with the ESOP for other reasons
4. Financial difficulty
5. New leadership not interested in perpetuating the ESOP
6. Company never intended for plan to be permanent
7. Other?

*NCEO Research available on this topic.*

# What's leadership's commitment to ESOP sustainability?

How important is the ESOP culture to…

- Leadership succession planning
- Talent acquisition and development
- Selection of board members

**Educate board, leadership, employees on ESOP – bring in experts as needed**

# Special considerations: An ESOP company Board

- Adopt ESOP and other qualified plans
- Retain and oversee ESOP advisors and fiduciaries
- Review valuation
- Determine contributions to ESOP
- Assess and plan for repurchase obligation
- Prepare response to unsolicited offer
- Declare C corporate dividends or S corporate distributions
- Understand effects of ERISA on corporate governance
- D&O and fiduciary liability insurance
- Corporate indemnification of board members
- Benefit Corporations
  - Legal Status administered by state, generally required to have a general public benefit purpose
  - Certified by the nonprofit B Lab to meet rigorous standards of social and environmental performance, accountability, and transparency

*A well structured, competent, and involved board of directors is one of the most effective means of protecting the interests of employee-owners in an ESOP company*

# Creating a sustainable ESOP

- Review/Evaluate
- Design/Plan and coordinate policies and procedures
- Incorporate ESOP into strategic and financial planning
- Reassess periodically and adjust
    - PLAN DESIGN CAN CHANGE!

# How is your ESOP working?

- Repurchase study – beginning of the process
  - Forecasts expected levels of share repurchases based on current plan design & employee population
  - Helps identify ownership concentrations or diversity
  - Identify upcoming repurchase bubbles
- What benefit are you delivering to your employees?
  - The benefit is the value of stock granted or allocated each year
  - What % of qualified payroll?
- How is stock getting to employee accounts?
  - Leveraged ESOP
    - Allocates a fixed number of shares over time
    - Eventually runs out of stock to allocate
  - Contributory ESOP
    - Annual decision to contribute cash or stock

# How is your ESOP working?

- Allocation Methods?
  - Formulas
  - Contributions vs S corp distributions
- What is your distribution policy?
- Employee involvement?
  - Are you getting the results you'd expect or like?
- Financial constraints?
  - Funding cash flow needs of business vs repurchase obligation

*Knowing what you know now, would you still design your plan the same way or would you have changed it?  If changed, how?*

# Design/Plan

- Is your ESOP intended to be a long term or short term benefit/ownership plan?
  - The answer to this question may change your decisions
  - Unless very short term, all ESOPs should be designed to function for the long run to maintain options and flexibility

- Identify short and long term corporate, shareholder, employee benefit goals: people, profits and planet

- Understand the implications of plan design on repurchase obligations
  - Loan amortization schedule (if leveraged)
  - Eligibility requirements
  - Vesting schedule
  - Allocation formula
  - Distribution policy

# Design/Plan

Identify and understand key drivers

- Strong business fundamentals
- Planning for capital allocation
- Timing of wealth transfer for ALL shareholders, including ESOP participants
- Focus on compliance. Keep the DOL and IRS happy!
- Short and long term focus at all stages of ESOP life cycle
- Have a plan for responding to offers
- Develop ESOP “Champions” and a commitment to ownership culture from leadership
- How your stock valuation is effected by your plans and repurchase obligation

# Design/Plan

- Consider recycling vs. redemption's impact on shareholder sustainability, etc.

- How do contributions vs. dividend/S distributions allocate shares. Assess how value is impacted by distributions and cash

- Develop a plan for the have's and have not's
  - Redeeming shares with a new inner loan
  - Offer early diversification
  - Adopt a creative allocation formula
  - Award equity outside the ESOP
  - Sell the Company?

# Strategic / financial planning for a sustainable ESOP company

- Understand and evaluate cash flow demands
  - Operating needs
  - Investment requirements
    - Capital expenditures & working capital
  - Debt service
  - Repurchase obligation
    - Unlike other obligations, ERISA requirement to make a market for participants who put their share kicks the repurchase liability to the top of the list
  - Liquidity needs of non-ESOP shareholders

- Limitations on access to capital of ESOP ownership
  - Access to non-bank capital may be very difficult for an ESOP owned company – especially when needed
  - Tendency of ESOP companies to self fund – resulting in large cash balances

# Understanding valuation implications

- ESOP valuation should reflect company plans
- Large cash balances may reduce risk but may reduce stock price growth
- Repurchase liability reduces available capital for reinvestment and may slow growth
- Stock redemptions can enhance stock price growth but may mask an erosion of enterprise value
- Impact to value redeem/recycle can only viewed in light of opportunity costs
- Assessment of impact on value of redeeming vs recycling is complicated and not an "all else equals" exercise

# What are your growth plans and how does the ESOP fit in?

- Organic
- Acquisitions
  - Pros and cons
  - Funding
  - Impact to value: short term vs long term
- Balancing competing demands for capital

# Does being an ESOP influence your appetite for risk?

- Positively or negatively?
- Balancing different participant constituencies
  - Nearing retirement vs. long way to go
  - Maximize value, protect retirement balances
- Does repurchase obligation influence your decisions?
- Leaderships stake in the ESOP
  - Problematic for newly hired executives?
  - Recruiting?
  - Synthetic stock plans?

# How do you get stock to new employees to perpetuate the plan?

- Leveraged ESOP
- Contributory ESOP
  - Cash and/or stock contributions
- Redeem / Recycle
  - Not mutually exclusive
- Dividends/distributions
- Forfeitures
- Re-leveraging

# Corporate Competition for capital

- Profits produce interesting challenges and absorb much of a management team's and Board of Director's time as they make important decisions that guide a company.
- 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?
- Are we supporting shareholder value and providing a good return on equity?

# 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
- Other outside shareholder returns/dividends
- Normal operations
- Expansion
- Retaining key management
- Effect of spending on value

*Balancing the cash needs of the plan sponsor and a mature ESOP requires careful analysis and will depend on the life cycle of the ESOP. Strategic oversight of these cash requirements is essential for sustainability and success of the Company and ESOP.*

## Companies sponsoring aging ESOPs must revisit their strategy/cash requirements to remain sustainable

- ESOP's 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.

**Consider the following example:**

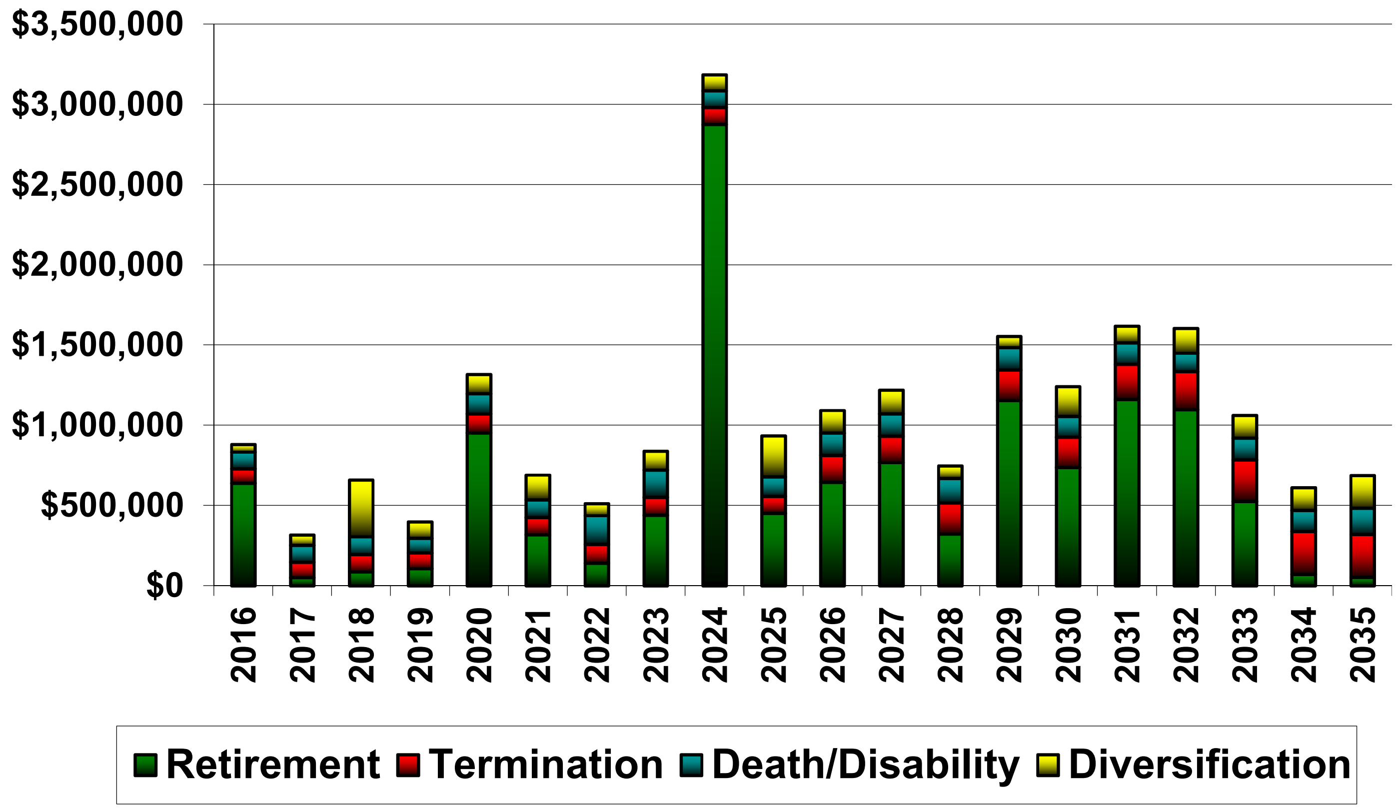
# Case Study - Small Mature ESOP

Facts on the ground:

- S-Corporation leveraged ESOP with 65% of shares in the plan
- ESOP loan will be paid off in 2019
- EBITDA is $3M
- Funds flows to the ESOP are $900,000 between $100,000 tax deductible contributions and $800,000 distributions of S-earnings or 17% of pay. Heavily skewed to long time employees who have the bulk of the allocated shares.
- Eligible payroll is $5.2 M with maximum allowable contributions of $1.3M
- Plan segregates terminee balances into cash which is in effect like having a provisions for lump sum payouts for all causes regardless of the reason for payout from the ESOP.
- ESOP has $1.6M of segregated cash in terminee accounts
- All shares are re-cycled in the plan during the distributions process
- The board has 5 defined contribution, discretionary deferred compensation agreements in place with key executives.
- No current repurchase problems but future years appear to be problematic

**Current practice of immediate liquidity to effect segregation regardless of reason for payout of all accounts, with no new stock issues or loan anticipation; 3% average annual share price appreciation.**

**Cumulative Stock Repurchase Obligations for Current Plan Through 2025 = $9.73 M; Through 2030 = $15.6 M.**




Consistent share price appreciation of 3% annually; no new stock issues; average retirement @ age 65 (early retirements assumed to be negligible); mortality per CSO 2000 tables; 6 year 100% vesting schedule; total salaries and number of employees grow at 2% annually; moderate turnover model (Sarason Table T5); all shares recycled in plan.

# Observations

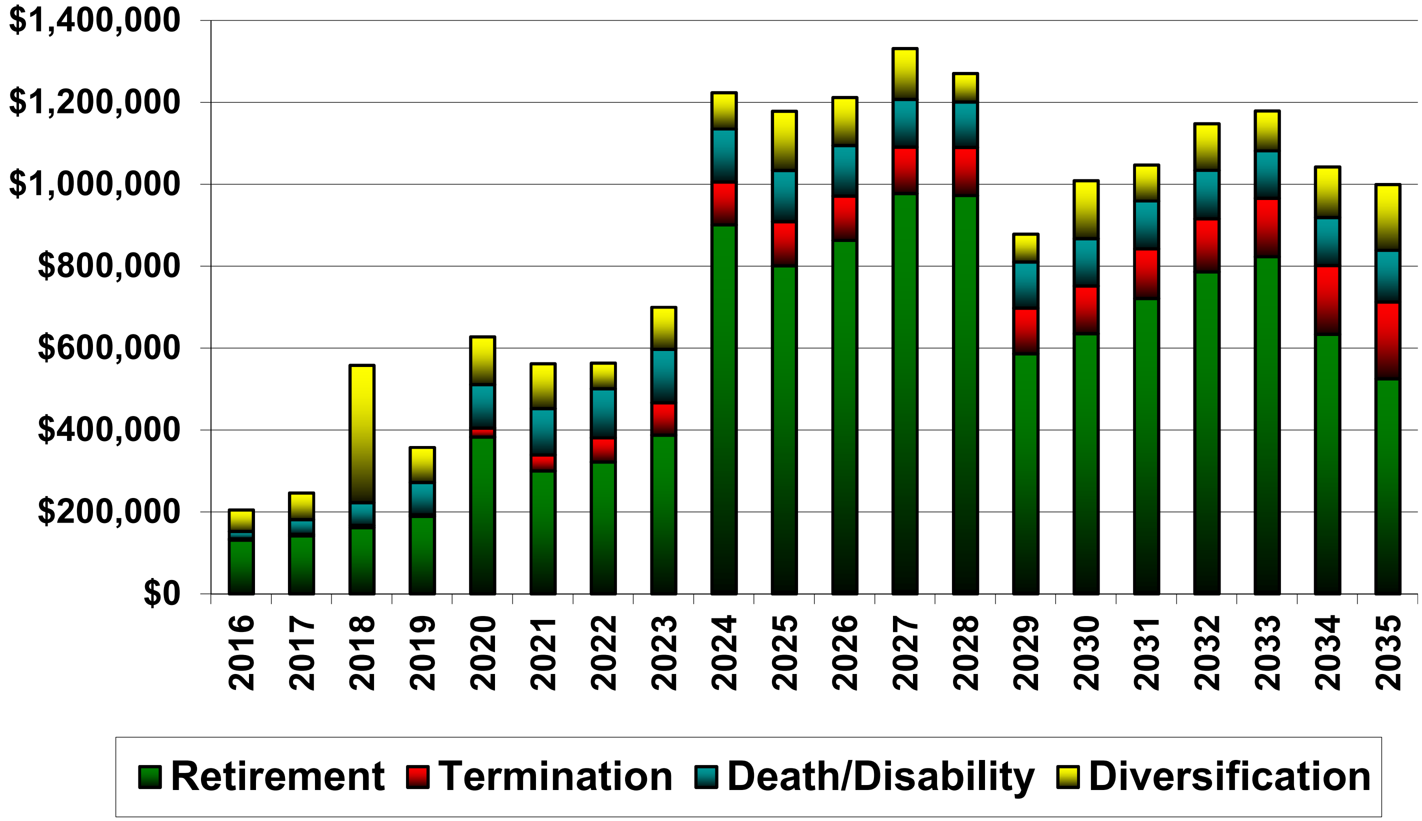
- In the year 2020, ESOP distributions of stock balances are projected to total $1.3M and will use more than the funds flows into the ESOP of $900,000 .
- In the year 2024, the ESOP buy back is over $3M, certainly more than they want to award the employees in that year if they simply continue to put funds in the ESOP and re-cycle shares.
- Consider a change in the distribution rules to smooth the repurchase obligation.

# Mature ESOP Strategy

- Prospective restriction of distribution rules to include a delay on starting terminee distributions and pay in installments if the plan allows for an outside policy and the flexibility to make a prospective change.
- 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

**Assume no new stock issues or loan anticipation plus maximum restrictive distribution rules for delayed payouts from vested account balances *held in stock*; 3% average annual share price appreciation.**

**Cumulative Stock Repurchase Obligations for Current Plan Through 2025 = $6.22 M; Through 2030 = $11.9 M.**




Consistent share price appreciation of 3% annually; no new stock issues; average retirement @ age 65 (early retirements are assumed negligible); mortality per CSO 2000 tables; 6 year graded vesting schedule; total salaries and number of employees grow at 2% annually; moderate turnover model (Sarason Table T5); all shares recycled in plan.

# Observations

- By simply maintaining a 3% increase in share value by flowing any excess growth into deferred compensation plans for key employees, a smooth appreciation trajectory is possible (watch 409(p)!) Remember a large S-dividend is also being paid in as well as a contribution each year. Average account balance increase is 19% per year with a 3% stock appreciation rate.

- By changing the distribution rules and removing segregation, the process of churning shares by buying them over and over is ended or reduced. The cumulative savings in the next decade is projected to be over $3.5M. Over the next 15 years the savings is over $3.7M.

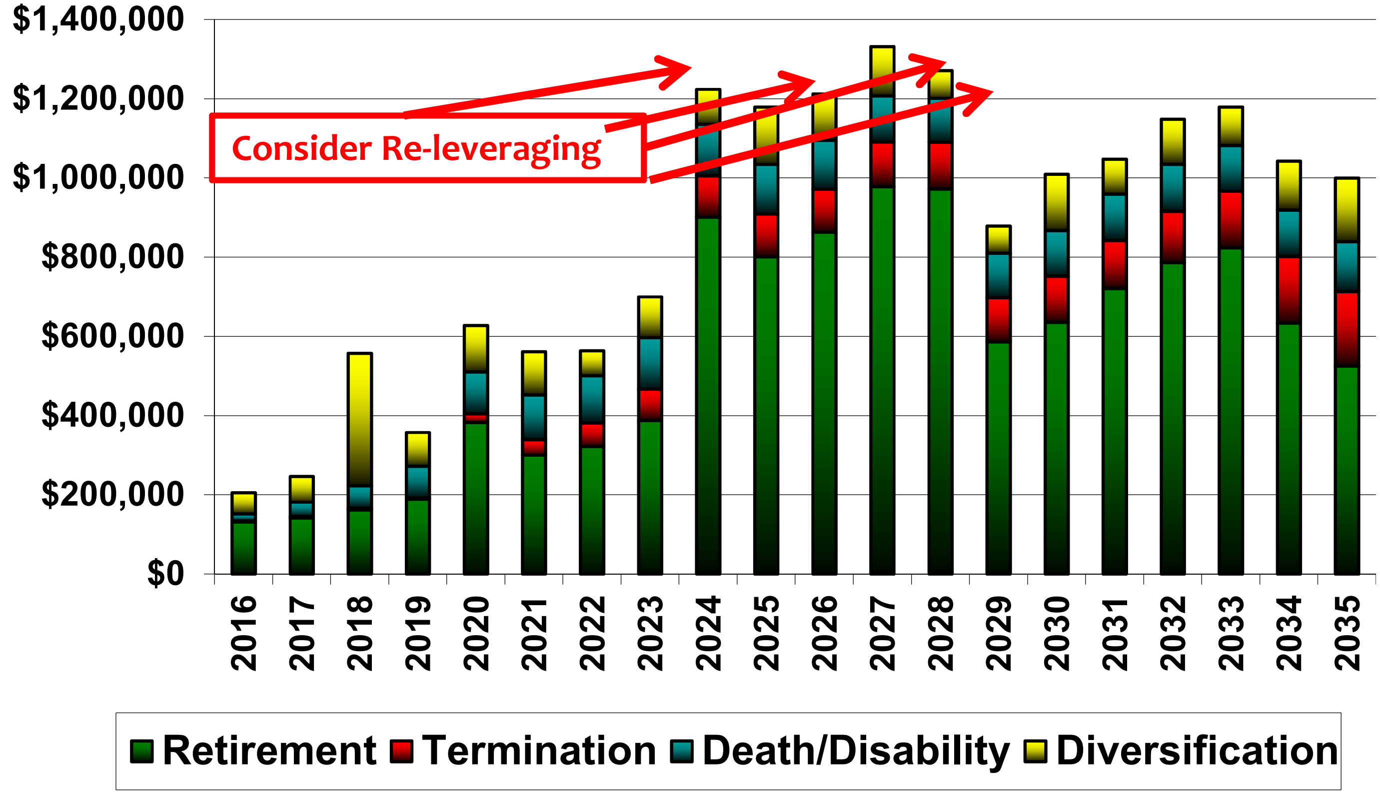
- Segregation is being eliminated and terminees hold shares. Even with terminees receiving appreciation and getting dividends, the overall obligations are reduced significantly.

# 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.
- The company plans to do corporate redemptions of all payouts in years where the repurchase is over $750,000 and sell the shares back to the ESOP for a 15 year internal note. The share release will be smooth and will go to all active employees including new hires. They understand they may have 4 outstanding loans at a time.
- The company will build up cash in the ESOP as the outside shareholders require tax equivalent distributions. As segregation is being eliminated, this cash will be used to buy future shares from the outside shareholders as they retire or for future ESOP distributions or expenses.

**Assume no new stock issues or loan anticipation plus maximum restrictive distribution rules for delayed payouts from vested account balances held in stock; 3% average annual share price appreciation.**

**Cumulative Stock Repurchase Obligations for Current Plan Through 2025 = $6.22 M; Through 2030 = $11.9 M.**

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# Re-Leveraging a Mature ESOP

- Redeem large stock distribution clusters of stock back into the corporation and sell them back to the ESOP with a long term loan.
- This slows the rate of later share allocations as the loan is retired.
- Pushes the greater share allocations into the future away from larger accounts nearing retirement, providing more for new hires. Helps deal with a "haves and haves not" scenario.
- The terms of bank loans for stock repurchases do not have to be mirrored by the company-to-ESOP loans.
- The alternative in 2024 to 2027 is to give much higher contributions plus S-distributions of earnings to the ESOP to fund the payouts.

For S-Corporations, avoid putting large K-1 distributions of earnings on shares in large stock accounts of near-term retirees to minimize cash outlays – <u>keep the cash on the balance sheet</u> as much as possible.

# Take Away

- Know what sustainability means for you
- Define sustainability objectives
  - Business perpetuation
  - To create liquidity for current shareholders, transferring ownership and leadership to employee owned company
  - To perpetuate an existing ESOP
  - To develop an ownership culture
  - To address the haves and have not's
  - Protect company from unsolicited offers
  - To…. ?
- Identify and address key considerations
- Continually reassess and expand your tool box to address your sustainability goals.

# Questions?

# Postscript

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# PROFILES

## Mary Josephs

Mary Josephs is the Founder & CEO of Verit Advisors, a specialized middle market investment banking firm. Ms. Josephs is a nationally recognized leader with more than 28 years of experience with ESOPS as a specialized solution-oriented succession and liquidity transaction for middle market companies. She has advised, structured and closed more than 300 financings and advisory projects for middle market companies representing more than $7 billion in senior credit and nearly $30 billion in enterprise value. Ms. Josephs holds a BA from Marquette University and an MBA in Finance from the University of Chicago. Ms. Josephs is a member of NASD: Series 24, 7, and 63. Ms. Josephs is on the board of Spinnaker Coating, LLC, Big Shoulders, a member of the Economic Club of Chicago, The Chicago Network and an alumnae of Leadership Greater Chicago.

Verit Advisors

## Paige A. Ryan

As a Senior Consultant for ESOP Services, Inc., Paige is responsible for all aspects of the firm's consulting services. She works directly with management, stockholders, board members, and their advisors to structure and successfully implement Employee Stock Ownership Plans (ESOPs). This is accomplished through gaining an understanding of corporate and shareholder objectives, and analyzing the ESOP's impact on the company, shareholders, and employees.

ESOP Services, Inc.'s unique approach emphasizes the financial aspects of ESOPs, including cash flow, tax savings, shareholder liquidity, and employee benefit levels, while coordinating the many diverse advisors and details necessary to successfully complete an ESOP transaction.

ESOP SERVICES, INC.

## Lisa J. Tilley

Lisa J. Tilley, CPA is Senior VP of Corporate Capital Resources LLC. She has assisted closely-held corporations in the design and implementation of employee benefit and succession plans for over twenty years. Her years as owner of a qualified plan administration practice allow her to support ESOP clients and their client professional service team members effectively. Lisa's particular expertise is corporate tax and ESOP accounting, with a focus on operational compliance and the coordination of plan operation with corporate cash and stock flows. Lisa speaks nationally on ESOP issues and is a graduate of Virginia Tech and alum of KPMG.

Corporate Capital Resources LLC

## Connie Woodmansee

Connie Woodmansee is a Pension Consultant and Manager of the ESOP Team at Swerdlin & Company. Connie has nearly 30 years of experience in the retirement plan and banking industry. She has been working with Swerdlin & Company for more than 14 years. Her experience includes plan design, government reporting, employee communication, and plan compliance and corrections. Connie's strongest areas of concentration are ESOP technical issues and compliance consulting. Connie is a member of the Ownership Culture Committee with The ESOP Association. She served many years as an officer with the New South Chapter and is currently serving as a member of the advisory committee. Connie has presented at local, regional and national ESOP Conferences.

Connie is a member of the NCEO, The ESOP Association, ASPPA, Atlanta ASPPA Benefits Council (ABC), the Institute for Certified Bankers, an subsidiary of the American Bankers Association and National Women in Pensions (WIPs).

Swerdlin & Company

## John O’Brien

John O’Brien is President of ComStock Advisors, an ESOP owned national financial advisory firm focused on providing valuation and transaction advisory services to privately-held companies. As President, John is actively involved in client engagements while managing ComStock’s operations. John has 25 years of experience in investment banking, valuations, and corporate finance. He has advised closely held companies regarding securities’ valuations and designing, financing, and executing transactions using employee stock ownership plans (ESOPs). He has also worked with the boards of companies to assess their strategic alternatives, advised on mergers & acquisitions, provided fairness and solvency opinions for corporate transactions, and consulting services to mature ESOP companies. John holds a MS in Finance from the Charles H. Kellstadt Graduate School of Business at DePaul University and a BBA from Loyola University Chicago. John is a member of: the ESOP Association and is a past member and currently associate member of its Valuation Advisory Committee; ESOP S Corporations of America (ESCA); and, the Business Valuation Association.

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