Capital Notes

Summer Update for Friends and Clients of Corporate Capital Resources

Corporate Capital Resources Newsletter Summer 2016

ZIRPs, NIRPs & ESOPs

In our not-so-brave economic world, it is clear that the powers-that-be are not just wary of higher interest rates, but are in fact slowly migrating to the alternate universe of Zero and even Negative Interest Rate Policies. It is remarkable that in all of the Western economies, the U.S. is the only one with a positive yield on all of its sovereign debt issues (thus the flight to "safety" in the dollar - at least for the time being). Switzerland, on the other hand, shows negative yields on all of its sovereign debt (and they have a AAA rating). Welcome to 'uncharted territory.'

A silver lining? We are not here to second guess the Fed Chair, Janet Yellin, but we can point to transaction opportunities in an environment where interest rates globally are trending lower and the fed has dug in its high heels on further significant rate increases (see the topic below on the current ESOP transaction environment).

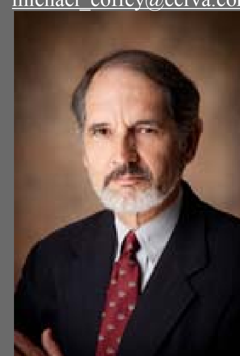
1. Since the Prime Rate rose to 3.5% in December of last year after seven years at 3.25%, we should expect some stability in that measure (though not necessarily a repeat of the seven year run at the lower rate).
2. Yellin herself has observed that the global economic slowdown affects the U.S. and continues the pressure on the Fed to maintain lower rates.
3. Yield chasing in this 'new normal' is a tough exercise - with the result of pushing more dollars into the equity markets. (The S&P 500 has given investors a sweet summer so far with its record high getting within 10 points of 2,200).

Quick Links

Check Out Our Website

Meet Our Professionals:

Michael A. Coffey
President
michael_coffey@ccrva.com



Lisa J. Tilley, CPA
Sr. Vice-President, Management Consultant
lisa_tilley@ccrva.com

The net effect of all this is a lower cost of debt capital, a rising level of market comparables used in valuations and continued interest by lenders in finding returns through lending which exceed the yield on the capital they are required to maintain.

W. William Gust
Consultant
bill_gust@ccrva.com

Thoughts on the ESOP Stock Transaction Environment

With current lending conditions and the recent recovery of enterprise value for many companies after the economic downturn of 2008, we are seeing an uptick in closely-held companies looking at tax-shielded ESOP stock transactions.

Banks are sitting on considerable cash and are now lending with favorable terms at the lowest rates we have seen (some senior debt @ 3.5% fixed for 5 to 7 year term loans).

Typically, when bank financing is utilized; the company borrows from a bank or lending institution and the loan proceeds are then lent to the ESOP in a second loan as part of the transaction between the company and the ESOP.

1. It is important to note that even when bank terms require payment within a seven year window or less, the secondary loan between the company and the ESOP to buy shares does not have to mirror the bank loan with the company either in terms of the interest rate or amortization period.
2. Depending on the plan sponsor's number of employees/size of the payroll versus the stock value being purchased, it may take longer than seven years to get the necessary cash in the plan to pay for the stock over the life of a loan. You can make the internal loan between the company and the ESOP over a longer term than the bank financing and release leveraged shares at an appropriate benefit level for the covered employees.

If you are contemplating installing an ESOP to move towards a transaction or already have an ESOP and are entering a second or third stage employer stock transaction, Corporate Capital can assist with the engineering of possible deal structures to see what makes sense, including actuarial forecasts of the ESOP repurchases required to pay out former participants under various scenarios.

Counter-balancing the appeal of the ESOP and its tax-favored liquidity is the increase in the M&A community's pursuit of the business succession market, typically offering more cash at closing and a better price. This begs an important question.

Can ESOPs Replicate Strategic Buyers?

Not entirely. This opinion is not shared by all practitioners in the relatively small world of ESOPs. It is possible to structure less-than-conservative, highly leveraged transactions with components such as warrants for departing shareholders which are then said to mimic a strategic buyer in terms of the IRR. Our view is that such mimicry is not perfect even with aggressive structures. Note the following:

1. A strategic buyer is bringing outside capital to the table, is not concerned with the type of fiduciary constraints imposed on ESOP and can tolerate post-closing covenants an ESOP cannot.
2. High ESOP debt loads often require the support (guarantees) of the selling shareholders. This support can be a greater financial requirement than the paper strategic buyers typically ask the sellers to hold.
3. An ESOP is a financial buyer basically applying its dividend-paying capacity over time to the costs of an internal business succession program. Yes, the ESOP multiples have increased a bit lately, but still do not compete with offers we have seen in some cases well north of 9X EBITDA from the strategic buyer.
4. Essentially an ESOP as a retirement plan represents an opportunity for controlling shareholders interested in the continuity of their corporate culture, in significant rewards for the loyal, long term employee and willing to commit to the time required for the process to receive 'Fair Market Value' for their equity interests - often with their support of the financial side of a transaction.
5. ESOPs work well with family-owned businesses looking to remain locally-owned where the rising family management needs to deliver real dollars to mom and dad, but also desires to improve the retirement program and retain control. An ESOP as a minority interest market can be extremely helpful.

Our conservative shop would observe that if the decision is made to pursue a strategic sale, the owners may want to have an ESOP financial study in their hip pockets as a "stalking horse." This would contrast the real ESOP deliverables with the promises of a strategic buyer.

The Evolution of Corporate Governance: Adding Outside Directors?

Yes, please.

Corporate governance of closely held small and mid-size companies continues to be an area requiring some careful attention.

Often, Trustees mandate that ESOP companies add one or more outside Board members to the mix to handle executive hiring, evaluation and compensation as well as oversee the hiring of corporate auditors and the financial reporting function.

Outside Board members should bring something special to the table such as industry experience, financial knowledge or possibly just an excellent "business sense". As the company contemplates and approaches new Board members for vote by the shareholders, how do you find the right fit? What are the defined duties of Board members? If duties are too heavy, you may scare off potential candidates who typically have busy careers already.

The Board is the linkage to ownership and serves at the pleasure of the shareholders. In an ESOP company, the Trustees are the legal shareholders, and at times, the 100% shareholders.

If your Board of Directors is 100% insiders, our view is that you consider adding one or two outside members. Always keep an odd number of Directors in accordance with your current by-laws. Virtually all of the companies we work with which have struggled with accepting outside directors are now supporters of the idea, even in family-owned businesses. The fears of oversight, compromised governance and the like have faded in favor of the better business decisions resulting from this fruitful cross-pollination.

Please contact us if you would like one of our summaries of BOD duties in an ESOP environment.

Department of Labor Update

The DOL remains active in its audit of ESOP companies and continues to use administrative subpoenas to request data upon beginning the audit of a plan sponsor. The ESOP community has recently reached out to DOL leaders to express concern over this practice and feels some response will be forthcoming.

The result of recent settlements of DOL litigation, (particularly the Sierra Aluminum/GreatBanc Trust case), there is now a clearer understanding of what the regulators want to see. As a result of this case, the ESOP community has been in direct talks with the DOL discussing best practices. A Fiduciary Process Agreement was settled on between GreatBanc Trust Company and the DOL that can be referred to as guidance for ESOP stock transactions. The result of that agreement can be distilled down to two very simple concepts: 1) The importance of process, and 2) The need for unbiased, independent representation of ESOP participant interests.

At CCR, we feel that in any stock transaction with an ESOP, in following the process agreement, you must:

1. Keep a focus on a conservative and sustainable transaction,
2. Making sure all vendor parties to a transaction are independent, and
3. Assure that the final negotiated transaction will/can survive just fine under the DOL microscope.

If you are currently operating an ESOP, please contact our offices for a variety of checklists to help understand the DOL audit process and the fiduciary requirements for Board members and ESOP Trustees. Bill Gust's presentations on surviving the audit process are also available and important reading.

Now is the time to get all this documentation in order.

A Few Words of Wisdom for Senior Business Leaders

Every day, we witness our client executive teams making decisions that shape the future of their companies and support the value of employer stock. It is our privilege to be a resource to each of these companies and at times, when peeking in "the corporate window" we are pretty surprised (not always pleasantly).

As ESOP and management consultants, we strive to keep our "finger on the pulse" of our economic and regulatory environment and bring helpful analysis and resources to our clients.
In an era of innovation when even some of our oldest client business models come under threat, we believe it is critical for organizations to be able to make rapid and effective decisions.

In a recent study published by the Chartered Global Management Accountant (CGMA), some key findings indicate that many organizations are struggling to:

1. Overcome bureaucracy and achieve agile decision making
2. Build greater levels of trust and improve collaboration
3. Take a long term view and define the right metrics to measure success
4. Turn huge volumes of data into strategic insight
5. Build the decision making skills of senior leaders

Top leaders of ESOP companies in particular recognize the need for more employee input in decision making, but struggle to make this happen. The survey indicates that 70% of executives admit there is moderate or significant room for improving active collaboration between leaders and employees and 65% say that they need to build employee trust.

While we see many of our clients working hard on these concepts, it is important to note, there is always room for improvement. Sponsoring an ESOP with employee beneficial ownership gives a company a leg up on employee engagement, but we find it is not enough to get them 100% engaged in their work without feeling they have a voice and a relationship with management.

Accumulating in meaningful formats all of the reporting and data that is available to executives is also a key driver to success. The CGMA survey indicates 80% of respondents admit that their organization used flawed data to make a strategic decision at least once if not more in the last few years. Careful structuring of "big data" available from the Business Operation, Accounting and Human Resource software packages used by the company into meaningful reports is critical for decision making by management as well as Boards of Directors.

Executive compensation is also an area we see that needs some attention and is verified by the CGMA survey. Only 39% of the respondents indicated they are confident their salary, benefits and bonus structures are helping strike the right balance in short, medium and long term enterprise value generation. CCR has performed many compensation studies for our clients and have seen the importance of structuring executive compensation packages that are tailored and meaningful for each executive and inspire them to perform at their optimum level.

As you challenge your senior leadership to make effective decisions in today's business environment; recognize a need for improvement and greater support in these five key areas:

1. Understanding how your enterprise is being valued and how to enhance the value
2. Interpreting new data sources
3. Learning from past outcomes
4. Enabling challenges to traditional thinking (not easy for any of us), and
5. Ensuring a deeper collaboration with employees.

How each organization approaches these topics and dynamics is totally different compared to other businesses but should be considered as the Board and Management work together to ensure success and to build shareholder value. It may be that your company needs to make hard changes to processes, resources and tools, but also softer changes to behaviors, culture and leadership styles to achieve an even higher level of success.

To quote the CGMA March 2016 report:

"Balancing both financial and non-financial information to capture a broader understanding of all the key value drivers, moving away from a solely traditional view of value in a business environment where that no longer makes sense" in our opinion, is essential to perpetuating the enterprise.

You can download the full CGMA report on decision making in the new era at:

http://www.cgma.org/resources/DownloadableDocuments/Joining%20The%20Dots%20-%20Report.pdf

Conference Season Presentations Are Available

CCR had a busy conference schedule last fall and this spring with presentations sponsored by both the ESOP Association and the NCEO. If you would like to download a copy of any of our presentations, please refer to our website in the resources section for the following presentation outlines:

1. ESOP Sustainability-ESOP Association Las Vegas and Trade Show-November 2015 Lisa Tilley
2. NCEO Webinar-Effective ESOP Committees-November 2015-Michael Coffey and Lisa Tilley
3. ESOP Association Mid-Atlantic Conference-Tips for Your ESOP Administration Cycle-March 2016-Lisa Tilley
4. ESOP Association Mid-Atlantic Conference-Sustainability-March 2016-Michael Coffey

5. NCEO ESOP Checkup-April 2016 Lisa Tilley
6. NCEO Executive Compensation/Coordination with ESOPs-April 2016-Michael Coffey

As we see summer speeding by and fall coming up we would like to thank you all for the opportunity to know and possibly work with you. Certainly, if you need anything from the CCR shop, please let us know.

We are a small consultancy and see ourselves as family. It is with great sadness that we announce that this edition of Capital Notes is in memory of Michael's beloved wife of 39 years; Debra Coffey, January 2, 1951 - April 28, 2016. Michael is profoundly grateful for the outpouring of support from CCR's friends and clients. It has been genuinely remarkable and is appreciated more than words can express.

Corporate Capital Resources, PO Box 12025, Roanoke, VA 24022-2025