

2023 ESOP VIRTUAL CONFERENCE

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Mature ESOPs:

An Overview of Redemption/Releveraging Transactions and Other Mature ESOP Issues

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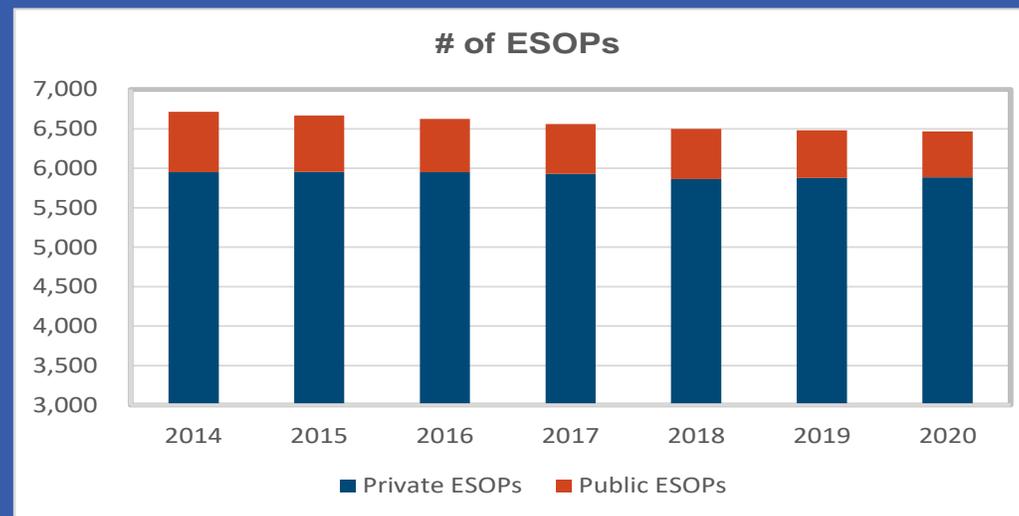
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An Uncomfortable Truth...

The number of ESOPs has declined in recent years.

According to the NCEO, the number of ESOPs has declined from 6,717 in 2014 to 6,467 in 2020. Despite adding 1,513 new ESOPs since 2014, 1,763 have been terminated during that same time period.*



* some terminations due to merger/acquisition with other ESOP companies

Why Do ESOPs Terminate?

- ESOPs have been good targets for M&A
- Management/next generation unable to be successful
- Repurchase obligation can become unsustainable
- Improper cash flow planning



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Life Stages of an ESOP

Newly Formed ESOP
(Years 1-5)

• What is a Mature ESOP?

- Transaction debt has probably been paid off (this includes bank debt, seller notes, and warrants)
- A significant number of ESOP shares have been allocated (internal loan may be fully repaid)
- Employees may have large account balances and be fully vested

Challenges for Mature ESOPs

- Managing benefit levels
- The “haves” and “have nots”
- Managing repurchase obligation and cash flow
- Sustainability

Value Composition During the ESOP Lifecycle

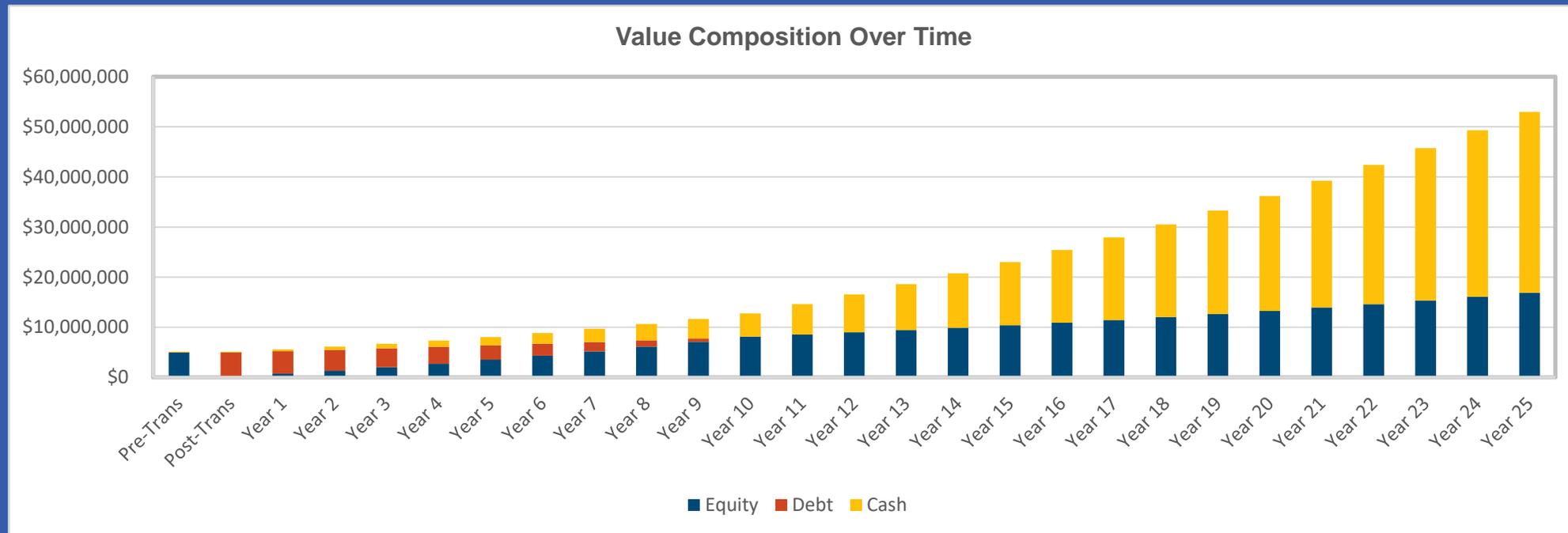


Illustration of a 100% S Corp

Benefit Level

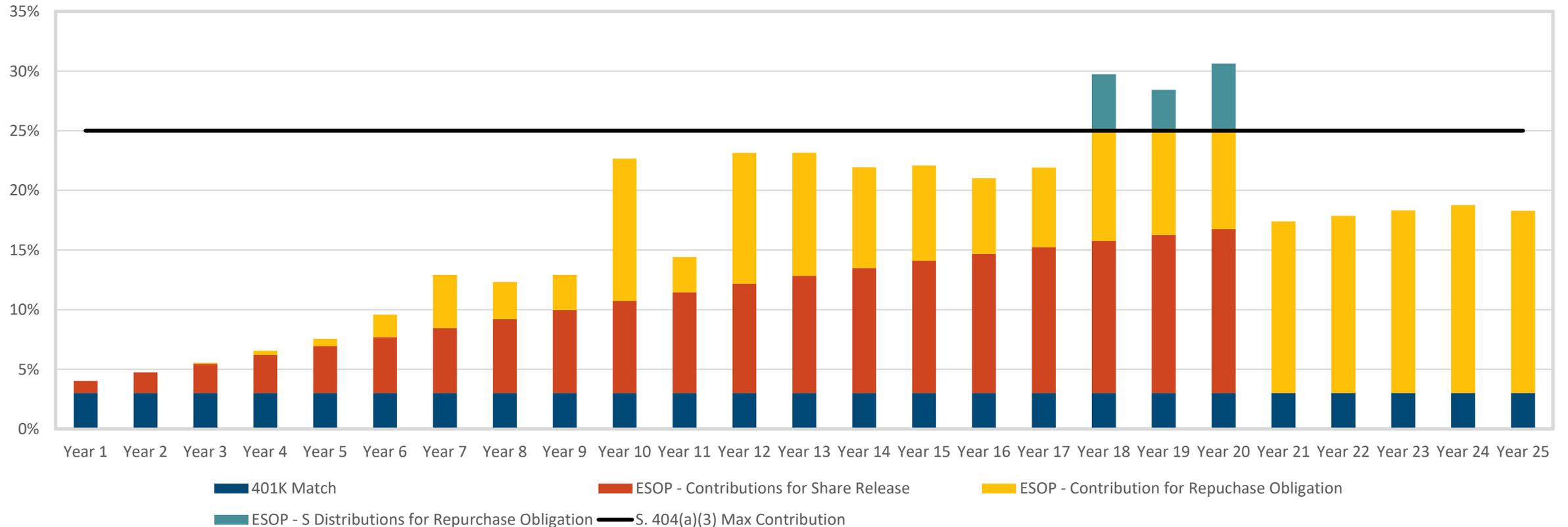
- The value of the amount allocated to ESOP participants as a percentage of compensation.
 - In simple terms: $\$1,000,000$ worth of allocations / $\$5,000,000$ payroll = 20% benefit level
- Allocations may come from:
 - Shares released from the suspense account
 - Company contributions
 - Forfeitures

Benefit Level

- The benefit level is affected by:
 - Value of shares released from the suspense account
 - Amount of contributions
 - Dividends/S-Distributions
- High benefit levels can motivate and reward employees and improve retention and recruiting efforts BUT result in increased repurchase obligation and potential compliance issues

Benefit Level Example

Retirement Benefits as a % of Payroll



Benefit Level – Targets / Factors

- New ESOP: Benefit may be low
- Mid-Age ESOP: Benefit may be very high
- Mature ESOP: May need to releverage to get the benefit “right”
- Challenges with maintaining targets
 - Employee headcount changes
 - Total compensation changes
 - Share value changes

The “Haves” and “Have Nots”

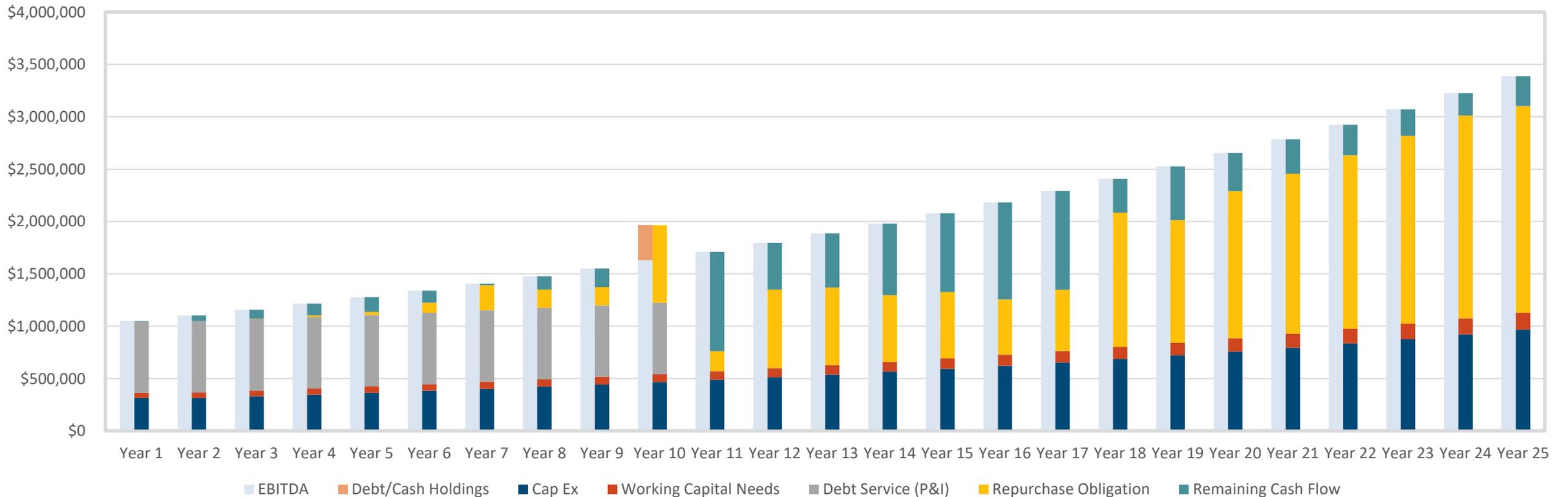
- Haves: Longer-term employees who have a significant number of shares allocated to their ESOP accounts
 - Share in the appreciation or depreciation of employer stock
- Have Nots: Newer employees who arrive after internal loan is paid off or substantially paid off
 - Do not share in the appreciation or depreciation of employer stock

Repurchase Obligation

- Obligation to honor the “put” option after employees leave (ultimately provide the cash value of the employer stock allocated to the participant)
- Obligation to provide cash when participants exercise diversification rights
- Code imposes minimum requirements for obligations with respect to distributions and diversifications

Repurchase Obligation

Repurchase Obligation Impact on Cash Flow
 (100% S Corporation)



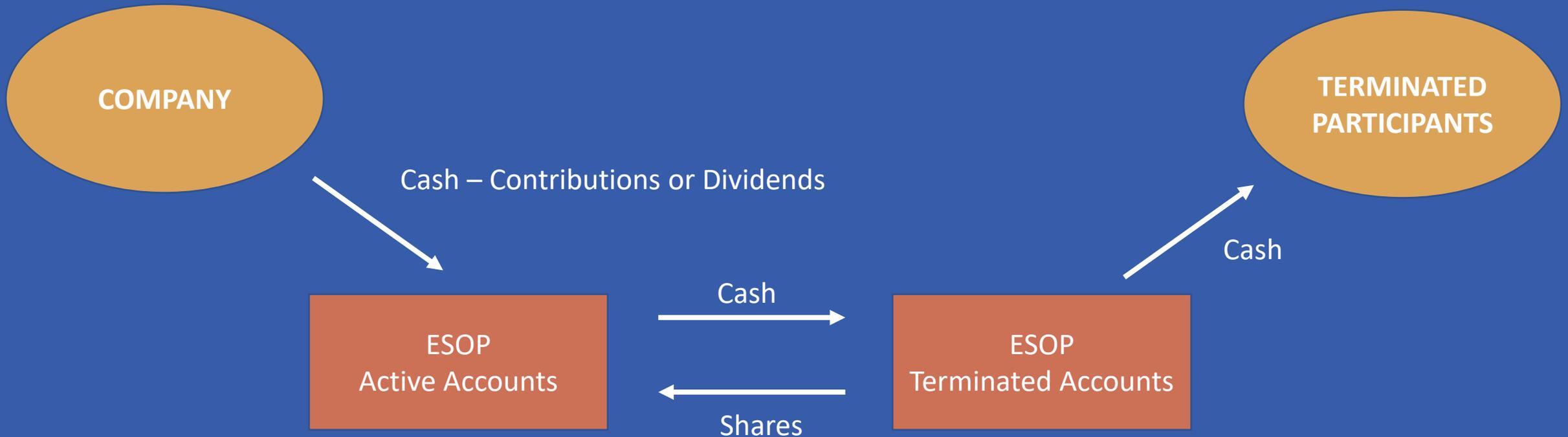
The Three Rs

- Recycle: Company contributes cash to the ESOP to fund distribution and diversification elections; shares from those accounts are allocated to current employees
- Redeem: Company purchases shares from the ESOP for cash
- Releverage: ESOP purchases employer stock with a promissory note

Recycling – *Shares remain in the Trust*

- Funding
 - Existing ESOP Cash - current and terminated participants with cash (exception for terminated balances that have been segregated)
 - Cash Contribution – current eligible participants
 - Dividends/S-Distributions
 - Unallocated Shares – typically same manner as Cash Contribution
 - Allocates Shares – share balances
 - Long term participants receive higher dividends
 - The haves have more
 - May create higher Repurchase Obligation

Recycling – *Shares remain in the Trust*



Recycling – *Shares remain in the Trust* Valuation Impact

- Contribution reduces earnings; dividends have no impact on earnings
- Aggregate Company value declines as cash leaves the Company
- Shares outstanding remain constant
- All else equal, per share value declines

| | Before | Participant Exchange | Recycle | After |
|-------------------------------|--------------------|----------------------|---------|--------------------|
| Enterprise Value | \$9,000,000 | | | \$9,000,000 |
| Less: Debt | (\$500,000) | | | (\$500,000) |
| Plus: Cash | <u>\$1,500,000</u> | (\$100,000) | | <u>\$1,400,000</u> |
| Equity | \$10,000,000 | | | \$9,900,000 |
| Divided By: Shares | <u>10,000</u> | (100) | 100 | <u>10,000</u> |
| Equity Value Per Share | \$1,000.00 | | | \$990.00 |

Redeeming – *Shares leave the Trust*

- Sale of shares to Company or Trust
 - Must obtain contemporaneous valuation on date of sale
- Payment directly to Plan Participant
 - Put Option must be executed
 - Special tax benefits may apply

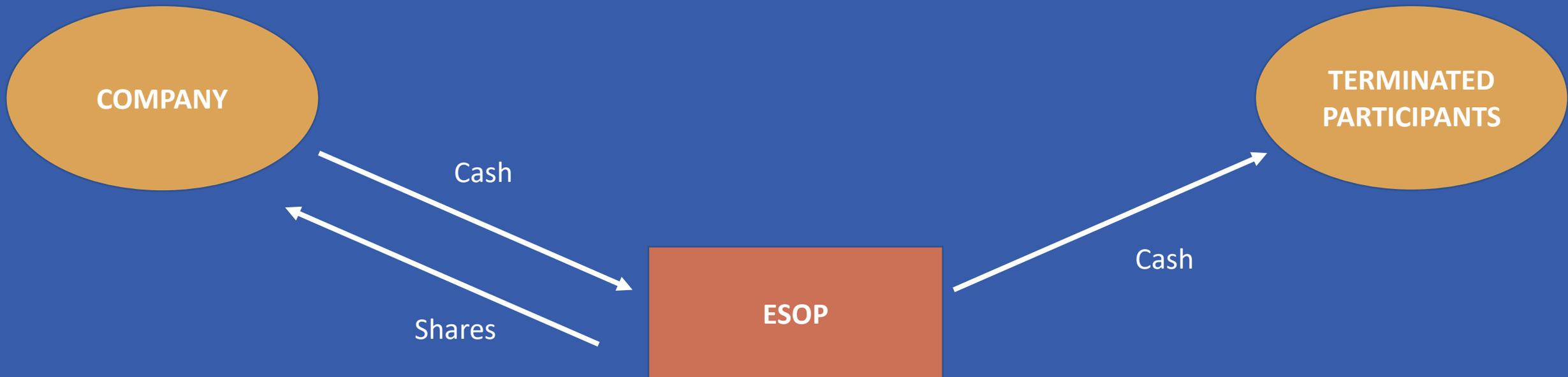
Redeeming – *Shares leave the Trust*

Option 1: Shares distributed directly to Participants; Company redeems



Redeeming – *Shares leave the Trust*

Option 2: Company Redeems Shares, Cash Distributed to Participants



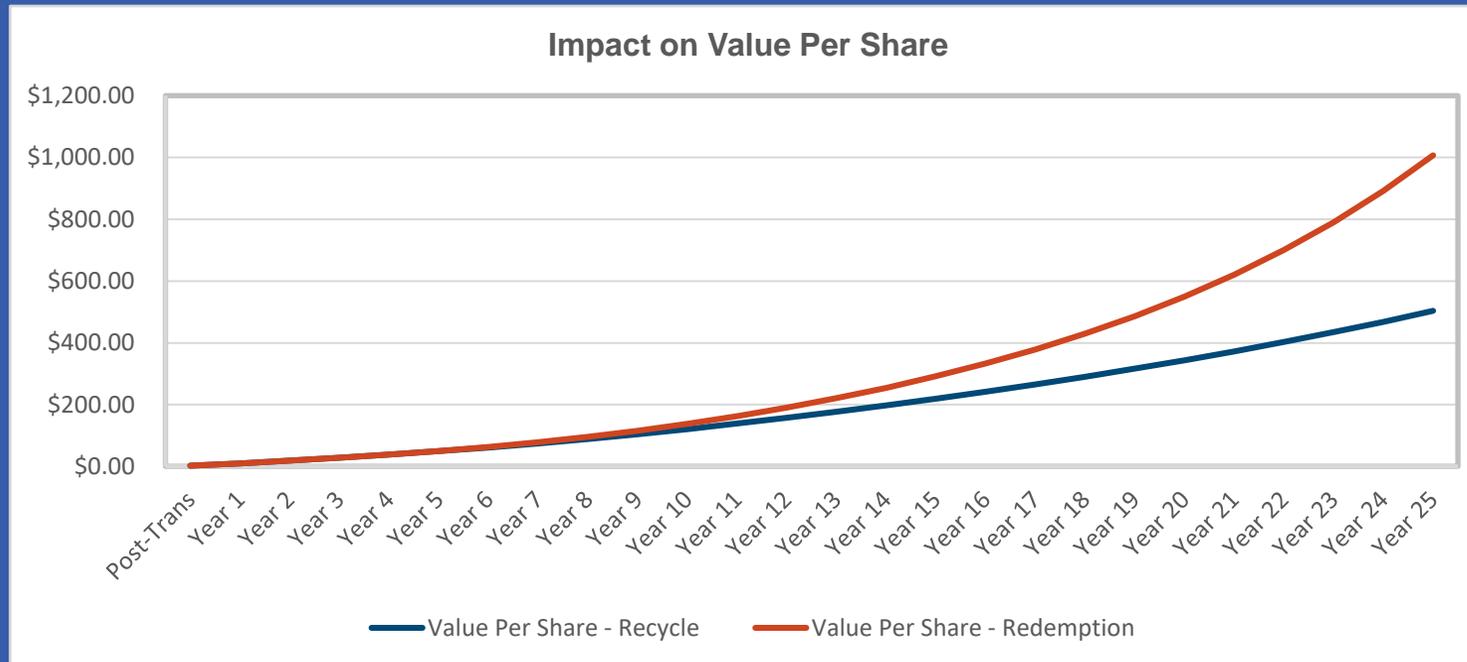
Redeeming – *Shares leave the Trust* Valuation Impact

- Aggregate Company value declines as cash leaves the Company
- Outstanding shares are reduced
- All else equal, no impact on value per share

| | Before | Participant Exchange | Recycle | After |
|-------------------------------|-------------------|----------------------|---------|-------------------|
| Enterprise Value | \$9,000,000 | | | \$9,000,000 |
| Less: Debt | (\$500,000) | | | (\$500,000) |
| Plus: Cash | \$1,500,000 | (\$100,000) | | \$1,400,000 |
| Equity | \$10,000,000 | | | \$9,900,000 |
| Divided By: Shares | 10,000 | (100) | 0 | 9,900 |
| Equity Value Per Share | \$1,000.00 | | | \$1,000.00 |

Impact on Value: Redemption vs. Recycling

When redeeming and retiring, the declining number of shares provides a higher value per share.



What happens to Redeemed Shares?

- Retired
- Recontributed
- Releveraged

Releveraging – *Shares sold to the Trust*

- Sale subject to internal loan provisions
 - Must obtain contemporaneous valuation on date of transaction
 - Debt payments release shares from unallocated
 - Use contributions for debt payments to allocate shares to current employees
- One time or Periodic
- Helps manage high repurchase obligations

Three More Rs

- Refinance: Extend payment schedule of original ESOP/internal loan
- Reshuffling: The mandatory transfer of employer securities into or out of plan accounts, *not* designed to result in an equal proportion of employer securities in each account.
- Rebalancing: The mandatory transfer of employer securities into and out of participant plan accounts, usually on an annual basis, designed to result in all participant accounts having the same proportion of employer securities

Action Items for Plan Sponsors

- Repurchase obligation study: recommended in the first 3 years, and then every 3-5 years thereafter based on growth
- Sustainability study: reviews corporate financials and layers in ESOP cash considerations
- Professional Summit: joint meeting among all advisors with key members of management

Take Away for Valuation Professionals

- Discuss plans for the ESOP – does the plan sponsor want to maintain the plan and provide for the sustainability
- Understand how different repurchase strategies impact value and can provide for an unsustainable plan
- Opportunities to provide guidance to the trustee and work with the third party administrator in modeling out future sustainability