Tools for ESOP Sustainability

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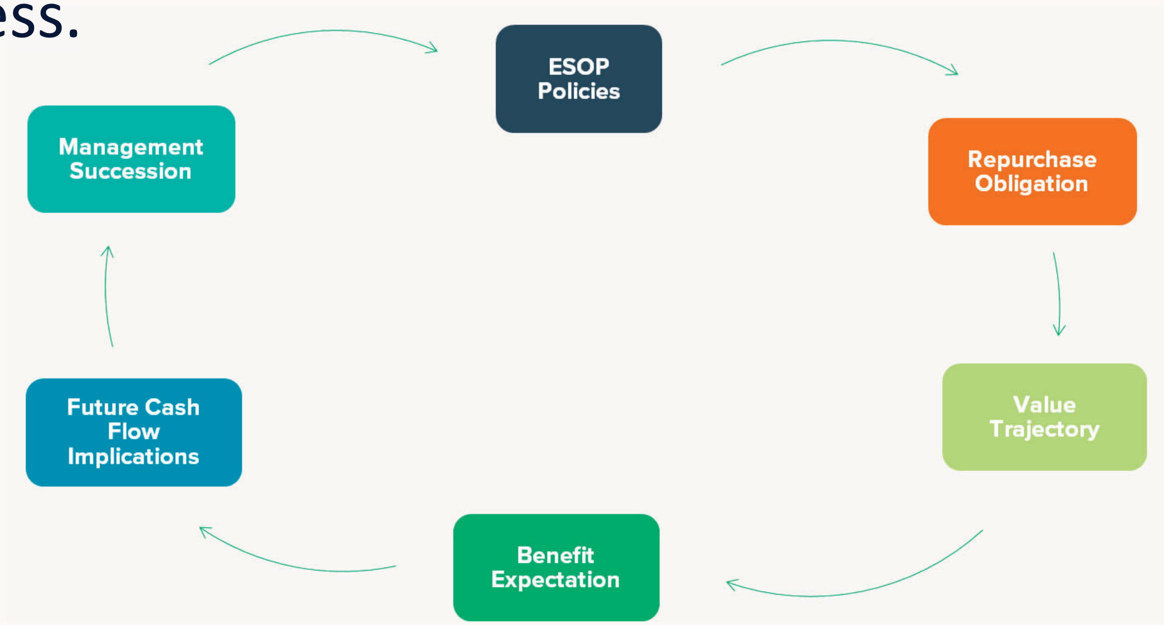
Agenda – Tools for ESOP Sustainability

- Keys to ESOP Sustainability
- Value Trajectory
- Benefit Expectation
- Future Cash Flow Implications
- Management Succession (ESOP Sustainability)

Keys to ESOP Sustainability

The topics below are interrelated and should be components of an ESOP-owned company's strategic planning process.



Keys to ESOP Sustainability

- ESOP repurchase obligation or liability is the company's obligation to buy back shares from ESOP participants according to the company's ESOP document and ESOP Distribution Policy.
- The obligation is created because the participant has the right to put the shares to the Company and the Company has an obligation to put back those shares. This dynamic is known as the ESOP put option.
- Repurchase obligation is not fixed, and it changes over time.

Keys to ESOP Sustainability

Repurchase Obligation ("RO")

- Can grow significantly as the ESOP matures
- Long-term employees – larger account balances
- Strong interrelationship between valuation and RO

RO Studies Common Issues

- Share price assumptions often an afterthought
- Policy decision can impact cash flows and valuation trajectory
- Incorrect share price assumptions can lead to poor management decisions
- Management should look to integrate cash flow and valuation analysis with expected shares to be repurchased

Value Trajectory

Value Trajectory

- RO Studies are prudent to perform (best practice)
  - Management needs this input to plan
  - Good tool for forecasting share repurchases
  - Often only reflect one outcome
  - Should understand impact under various scenarios
  - Provide tools for management to assess strategies under different outcomes
  - Helps trustees and management under where benefit levels are going
- Too often share price is an afterthought
  - Incorrect share price assumption can lead too poor management decisions
  - Need to integrate valuation
  - Integrated analysis provides useful output
  - Need to incorporate S-Corp benefits into management's thinking

Value Trajectory

- Repurchase obligation studies provide the who, when and how many shares
- Share price is treated as just another input and is often based on static assumptions, e.g. 8.0% growth
- Share price needs to be dynamic input based on:
  - ESOP strategy
  - Benefit target
  - Expected cash flows

Value Trajectory

- Share price trajectory will differ between two strategies
- Under recycle strategy, share price will be suppressed over time due to the reallocation of purchased shares
- Under redemption strategy, share price will be greater than under a recycle strategy

Recycle Scenario

	Pre-	Paid to Participants	Shares Recycled	Post-
EV	$5,000			$5,000
Cash	500	(275)		225
Equity	$5,500			$5,225
Shares	100	(5)	5	100
Price/Share	**$55.00**			**$52.25**

Redemption Scenario

	Pre-	Paid to Participants	Shares Recycled	Post-
EV	$5,000			$5,000
Cash	500	(275)		225
Equity	$5,500			$5,225
Shares	100	(5)	0	95
Price/Share	**$55.00**			**$55.00**

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Value Trajectory

- In both cases, the 100.0% ESOP had a final value of $5,225, but there is a difference in:
  - Share price
  - Outstanding shares
- The repurchase obligation will need to be adjusted based on the strategy and the correct share price trajectory
- Future repurchase obligation is directly impacted based on the strategy employed each year
- In order to properly target a benefit level, an accurate share price trajectory is required based on the strategy employed by the Company

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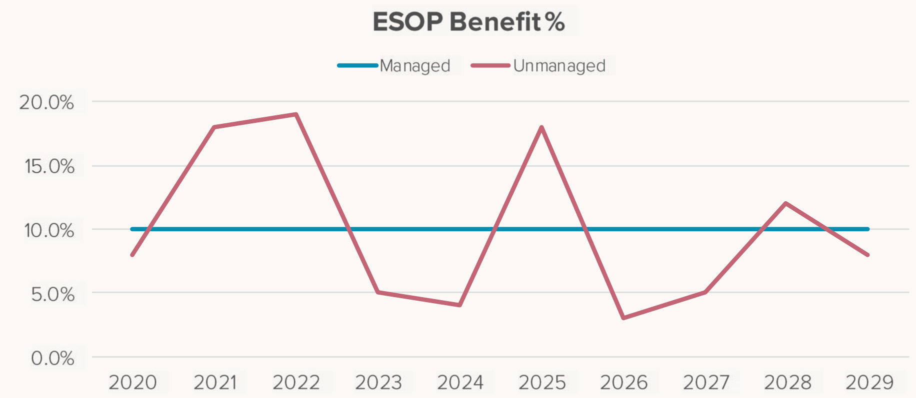
Benefit Expectation

Benefit Expectations of Your ESOP

- The ESOP is just one component of a company's benefit package
  - 401K
  - Profit sharing
  - Health care (medical, dental, optical)
  - ESOP
- ESOPs can be used to acquire and retain talent, but it is important to understand and communicate effectively what that benefit is and will be in the future
- Targeting a benefit for the ESOP will also simplify communication to current participants

Repurchase Obligation

- 100.0% S-Corp
- Company policy is to recycle all ESOP shares
- Contribute to ESOP as needed
- Over time, benefit levels vary significantly
  - Not in line with market
  - Difficult to communicate to employee base



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Future Cash Flow Implications

Future Cash Flow Impacts

- Management needs to understand how the ESOP, cash flow requirements and corporate decisions interrelate
- Integrated impact of debt, capital expenditures, profitability, RO, S-election, etc.
- Stress test your modeling
  - Base case
  - Recessionary impact
  - Hyper growth impact

Future Cash Flow Impacts

- RO with poor value trajectory assumptions may lead to poor decisions
  - Hoard cash when not necessary
  - Spend cash when requirements exist
- Based on policies, ESOP cash may be available to satisfy RO needs
- Output from this type of analysis needed to assess potential insurance needs

Management Succession

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Future Cash Flow Impacts

- Does the company have strong successor management?
  - Need to develop talent to sustain ESOP ownership (knowledge drain)
  - May need to look outside
- What is the right ownership mix?
  - 100.0% ESOP (if not already)
  - ESOP/MBO
  - Synthetic Equity
- Does company want to remain an ESOP indefinitely?
  - If not – may want to prepare company for sale well in advance of ultimate sale
  - Align benefit levels with market
  - More seamless transition
  - Will help to secure an appropriate value from acquirer

Questions?

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