The California/Western States Chapter of The ESOP Association

ESOP Sustainability: Keeping it Going

CAWS Chapter Conference | South Lake Tahoe

October 3, 2019

The ESOP Association

- The CAWS Chapter is **your** local chapter of The ESOP Association. There are 18 chapters across the country.
- As a member of this chapter you are **automatically enrolled, at no additional cost,** in the national ESOP Association.
- Your membership provides you with **free** materials and **discounted** conferences, publications, and more.

Visit **ESOPAssociation.org** to learn more.

The California/Western States Chapter of The ESOP Association

Agenda

- Defining Sustainability
- Common Sustainability Concerns
  - “Haves vs. have-nots”
  - Repurchase Obligation
  - Benefit Levels
- Young ESOPs: Understanding the consequences of your plan design
- Mid-Life ESOPs: Revisiting distribution policy and diversification
- Mature ESOPs: Benefit levels, releveraging, & other creative solutions
- Conclusions

Defining Sustainability

The California/Western States Chapter of The ESOP Association

Defining Sustainability

- To keep in existence, maintain, continue, or prolong
- What makes an ESOP Sustainable?
  - Company is able to afford ESOP cash requirements
  - Long-term benefit provided for ESOP participants
  - ESOP policies align with corporate strategies, long-term goals
- Who is responsible?
  - Board, Trustee, Management?
- ESOP sustainability is dependent on business sustainability

Strategic Planning

- Our company has an annual strategic planning meeting with the Executives and the Leadership Team.
- We come up with ideas on how to increase revenue and reduce costs.
- The Strategic Plan is reviewed by the Board of Directors. It has to be approved before we continue.
- Our Annual Operating Plan is based on the approved Strategic Plan.
- Our Final Annual Operating Plan has to be approved by the Board of Directors.
- Example for HR: Implement a Performance Management System and Incentive Program

The California/Western States Chapter of The ESOP Association

Strategic Planning cont’d

- The Strategic Plan is reviewed each month with our Executive Team.
- The Strategic Plan is reviewed in detail each quarter with the Leadership Team.
- We review the overall goals with all of our employee-owners on a quarterly basis.
- Goals may change due to many reasons: economy, competition, natural disaster, industry standards, government regulations, etc.
- Be ready for change – it happens each day!

Haves vs. Have-Nots

- Shares largely concentrated in accounts of long-term participants (**the “haves”**)

  vs.

- Not many shares in accounts of newer participants (**the “have-nots”**)
- Could also refer to large % of shares in accounts of former employees (“haves”) vs. active employees (“have-nots”)

Haves vs. Have-Nots

- "Haves vs. Have-nots" might emerge if:
  - Short ESOP loan schedule, prepayments on ESOP loan
  - Long distribution delays / installment periods
  - ESOP is heavily funded with dividends or S corp distributions (partially-owned S corp ESOP)
  - ESOP RO handled with redemptions (more on this later)

Sustainability Challenges at CPI

- We've had 4 Company Presidents since 1991. 3 Internal and 1 External. (The External President only lasted 10 months).
  - We now have a formal succession plan that is reviewed and approved by our Board of Directors each year. This includes all of the Executive Team and their direct reports.
- Technology challenges – we weren't ready for 2000. We thought everyone needed our products with the Y2K issues. They didn't.
- Which led to Financial Challenges:
  - We had our first layoff in 2001 (30% of our employees). We should have had the layoff in 2000. We made decisions with our hearts and not by the numbers. (We were close to bankruptcy).

Sustainability Challenges at CPI cont'd

- With the layoff, we couldn't afford our current ESOP Distribution Policy. (Immediate payout).
  - We legally changed the distribution policy right before the layoff. (5 year waiting period – distribution starts the year AFTER the 5 year waiting period). We had to what we had to do to keep our company and the ESOP alive. If we didn't change our ESOP Distribution Policy, we would've been out of business and no one would have received any payout.

- The change in distribution policy led to a lawsuit by former employees. The cost of the lawsuit was not in our plan and cost a lot of money.

Sustainability Challenges at CPI cont'd

- New employees not understanding the ESOP and what it means to be an employee owner.
  - We are continually changing our new hire orientation.
  - We try to keep the ESOP language in most of our communications.
- Perception with new employees: Have and Have Nots:
  - We have reduced the allocation percentage
  - Newer employees are not receiving as many shares – neither are the long-time employees (because we all receive the same percentage).
  - The long-time employees have larger account balances due to the share price increasing. This is also true for all employees since they have shares and the price has increased.
    - Communicate, Communicate, Communicate. Let them understand how long-term investments can increase in value and how as an employee owner they can make a difference and increase the share value.

Repurchase Obligation

- Large ESOP RO may mean:
  - ESOP cash needs exceed Company cash flow or limit ability to invest and grow
  - ESOP cash needs exceed qualified plan limits
    - 404 Deduction Limit (25% of qualified payroll): Limits company's ability to contribute to other plans, requires supplemental funding strategy for ESOP
    - 415 Allocation Limit ($56,000 in 2019): Limits individual participation in 401(k) and individual benefit in ESOP
    - 409(p) – Anti-Abuse Limits: Too many shares allocated to too few people

Repurchase Obligation

- Closely-held ESOP company's obligation to buy back shares of stock from ESOP participants due to:
  - Termination of employment (death, disability, retirement, or turnover)
  - Election of diversification rights at age 55 with 10 years of plan participation

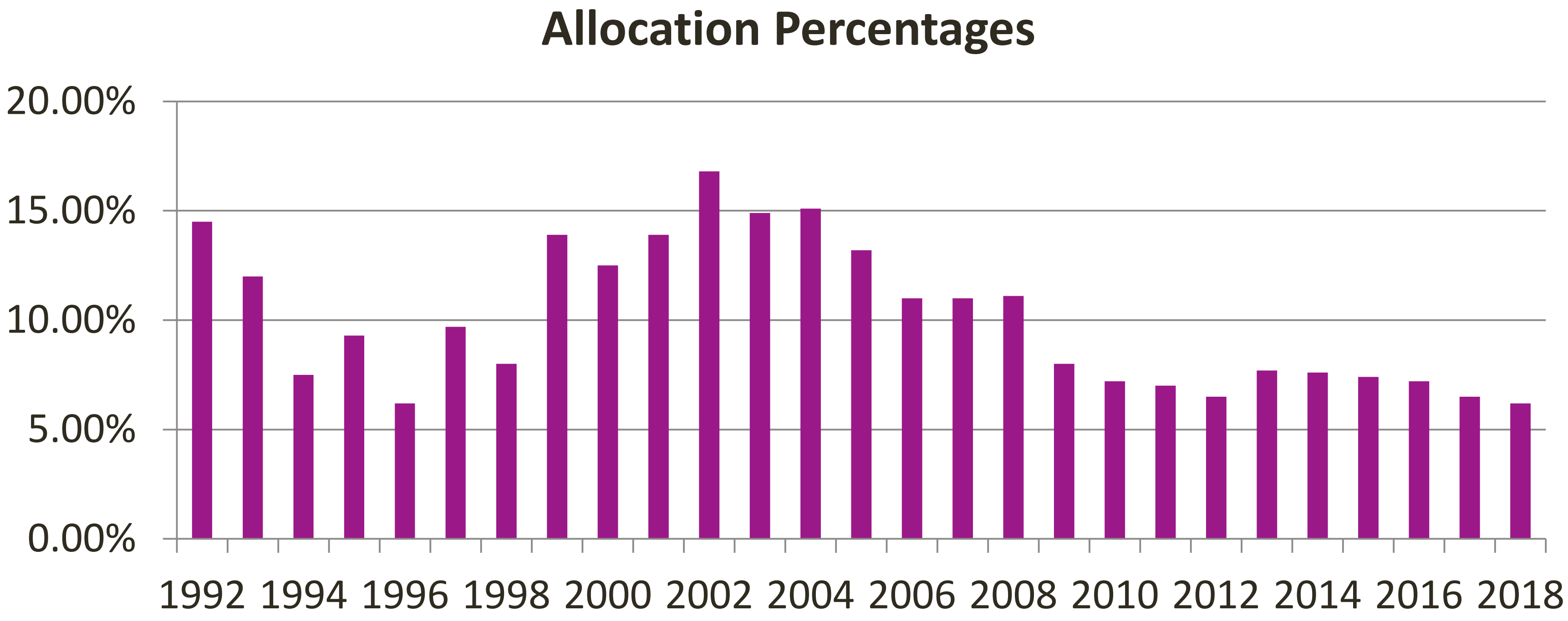
Benefit Level

- Benefit level =
  - Value of stock or other investments from contributions (net of ESOP loan payments) **+**
  - Value of reallocated forfeitures **+**
  - Value of shares released from ESOP loan suspense with contributions
    - *Note distinction between contributions used to fund ESOP loan payments & value of shares released from ESOP loan suspense*
  - Generally does <u>not</u> include dividends or changes in value per share
  - Measured as a % of qualified payroll

Benefit Level

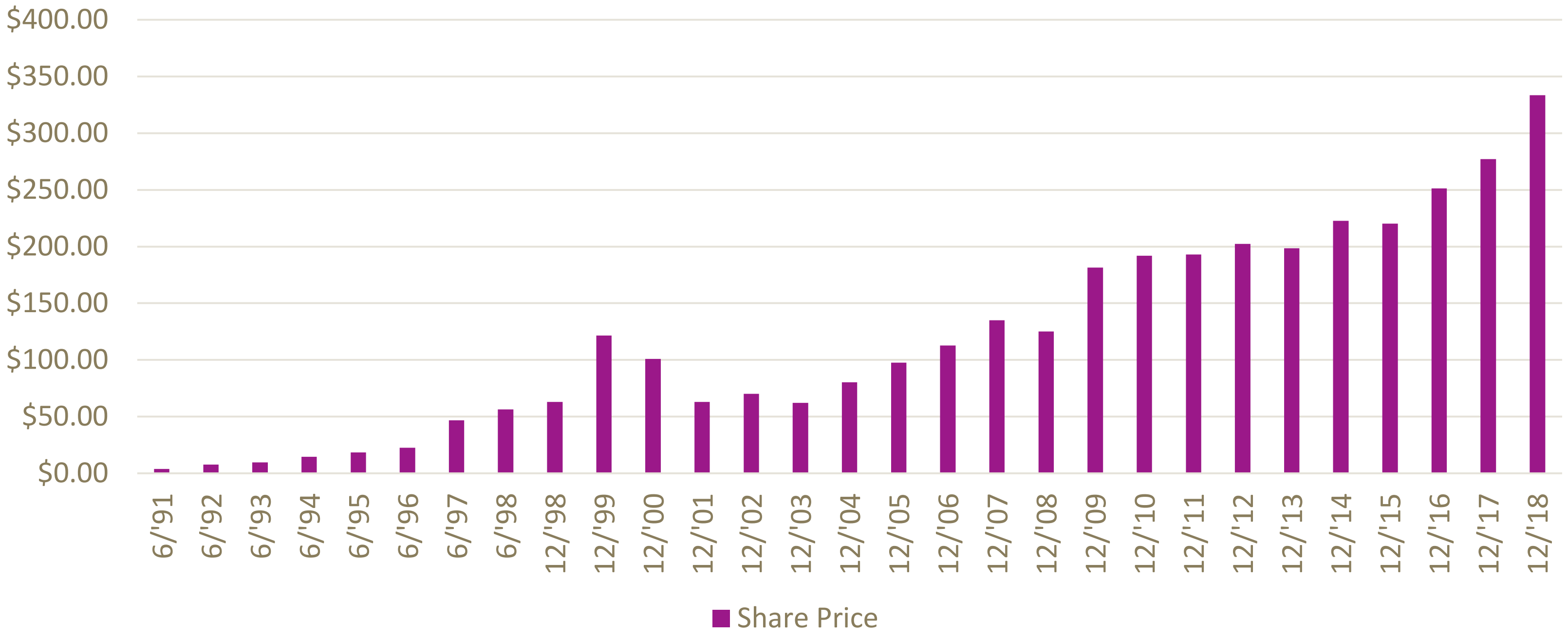
	Benefit Level	Return to Shareholder
Stock contributions	x	
Cash contributions not used for loan payments	x	
Value of shares released from loan suspense with cash contributions	x	
Value of shares released from loan suspense with dividends/S corp distributions on <u>unallocated</u> (loan suspense) shares	x	
Value of shares released from loan suspense with dividends/S corp distributions on <u>allocated</u> shares		x
Dividends/S corp distributions on allocated shares		x
Change in value per share		x

Our Share Allocation History since 1991



The California/Western States Chapter of The ESOP Association

Our Share Price History since 1991



The California/Western States Chapter of The ESOP Association

Plan Structure & Design

- ESOP loan term (the *internal* loan)
  - Mechanism for allocating shares, affects level of benefit provided
  - Impacts timing of ESOP RO
- Vesting
  - Credit for prior service → immediate ESOP RO
- Distribution policy
  - Many companies pay lump sum distributions when ESOP RO is low
- Plan and structural design affects benefit levels

Mid-Life ESOPs – *10 – 20 years*

Revisiting distribution policy and diversification

Diversification

- Statutory Diversification
  - Age 55 with 10 years of plan participation, 6-year window
  - Eligible participants can diversify 25% of stock account in first 5 years, cumulatively, and an additional 25% in sixth and final year
  - Actual ESOP RO depends on election rates
- Enhanced Diversification / In-Service Distributions
  - Can be used to smooth out ESOP RO
  - Gets shares to new participants sooner
  - Additional diversification opportunity for participants

Distribution Policy

- Distribution Options
  - Immediate vs. delayed distributions
    - Immediate distributions tend to accelerate ESOP RO; delayed distributions result in former employees holding stock
  - Lump sum vs. installments
    - Lump sum distributions tend to accelerate and increase year-to-year variability of ESOP RO; installment distributions smooth out ESOP RO
  - Segregating accounts
    - Similar to lump sum distributions, though can be employed differently

Repurchase Strategy

- Redeeming:
  - Shares are purchased by company and leave ESOP
  - Repurchased shares can be retired, recontributed, or sold back to ESOP in a “releveraging” transaction (more on this later)
- Recycling:
  - Company puts cash into ESOP to repurchase shares
  - Repurchased shares are reallocated immediately to eligible participants

Redeeming

- If redemption strategy results in a declining number of shares outstanding:
  - May affect ESOP’s ownership % (if < 100% ESOP)
  - May cause value per share to rise more rapidly than aggregate equity value
    - Potential issues communicating company performance to participants
    - ESOP RO not likely to be any less expensive – ESOP will own fewer shares, but shares will be repurchased at a higher value

Recycling

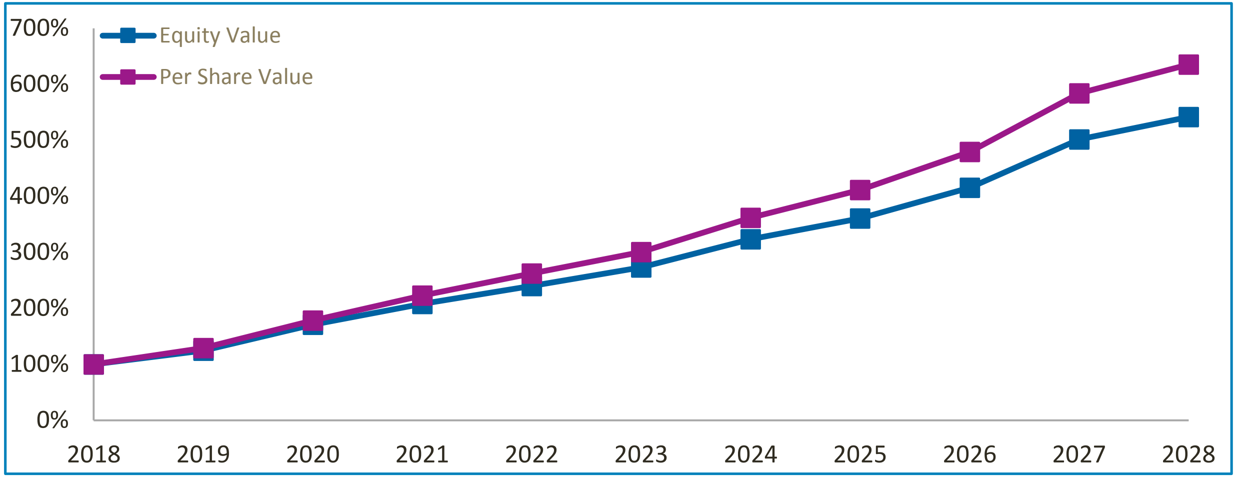
- 2 Ways to get cash into ESOP to recycle shares:
  - Contributions: Allocated pro rata to compensation
    - Provide a “benefit to participants”
    - Subject to 25% contribution limit
  - S Corporation Distributions: Allocated pro rata to shares
    - Provide “shareholder return”
    - Can concentrate shares in accounts of long-term participants nearest retirement age, increasing ESOP RO
    - Can also be inefficient, depending on distribution policy

Redeem vs. Recycle

GROWTH IN EQUITY VALUE VS. VALUE PER SHARE									
			Redeeming			**Recycling**			
Year	Equity Value	Equity Value Growth Rate	Shares Outstanding	Value Per Share	Value Per Share Growth Rate	Shares Outstanding	Value Per Share	Value Per Share Growth Rate	
	$ 50,000,000		1,000,000	$ 50		1,000,000	$ 50		
1	52,500,000	**5%**	955,000	$ 55	**10%**	1,000,000	$ 53	**5%**	
2	55,125,000	**5%**	908,000	$ 61	**10%**	1,000,000	$ 55	**5%**	
3	57,881,250	**5%**	859,000	$ 67	**11%**	1,000,000	$ 58	**5%**	
4	60,775,313	**5%**	808,000	$ 75	**12%**	1,000,000	$ 61	**5%**	
5	63,814,078	**5%**	755,000	$ 85	**12%**	1,000,000	$ 64	**5%**	
6	67,004,782	**5%**	700,000	$ 96	**13%**	1,000,000	$ 67	**5%**	
7	70,355,021	**5%**	643,000	$ 109	**14%**	1,000,000	$ 70	**5%**	
8	73,872,772	**5%**	584,000	$ 126	**16%**	1,000,000	$ 74	**5%**	
9	77,566,411	**5%**	523,000	$ 148	**17%**	1,000,000	$ 78	**5%**	
10	81,444,731	**5%**	460,000	$ 177	**19%**	1,000,000	$ 81	**5%**	
CAGR		**5%**			**13%**			**5%**	

Redeem vs. Recycle

- A declining number of shares outstanding results in value per share growing faster than equity value



The California/Western States Chapter of The ESOP Association

Redeem vs. Recycle

	Redeem	Recycle (Contributions)	Recycle (S distributions)
Shares outstanding	Reduced	No impact	No impact
ESOP ownership	Reduced if <100%	No impact	No impact
Add'l shares to EE accounts	No	Yes	Yes
Employee group benefitted most	Longer-term Ees with larger share balances	All employees (pro rata to comp)	Longer-term Ees with larger share balances
Per share value	No dilution	Dilution	Dilution
Corporation's cash flow	Reduce	Reduce	Reduce
Income tax	No deduction	Deduction for contribution	No deduction

Mature ESOPs – ***20+ years***

Benefit levels, releveraging, and other creative solutions

The California/Western States Chapter of The ESOP Association

Benefit Levels & Sustainability

- Many companies make ESOP contributions on an as-needed basis to recycle repurchased shares (i.e., “pay-as-you-go” funding)
  - Benefit levels driven by ESOP RO
  - Contributions (therefore, benefit levels) may be high compared to non-ESOP companies
  - Contribution requirements may vary significantly from year to year
- Common advice is to manage ESOP RO in ways to avoid benefit levels that are “too high”
  - Limit benefit to target level and handle excess ESOP RO by either redeeming shares or paying S corp distributions to recycle shares

Benefit Levels & Sustainability

- *Myth: a high benefit level makes an ESOP unsustainable*
  - Sustainability depends on <u>cash</u>
  - Many ESOP companies with very high benefit levels also generate ample cash flow
  - Techniques for managing benefit levels (i.e., redemptions & S corp distributions) have consequences that can exacerbate ESOP RO
  - ESOP RO in a 100% ESOP company is usually high relative to a "normal" benefit level in a non-ESOP company

Releveraging

- Shares redeemed by company and sold back to ESOP w/internal loan; shares reallocated as loan is repaid
  - Can be used on one-time or periodic basis, in years of high ESOP RO, or on annual basis to fund ESOP RO shortfalls
  - Reallocating shares over long period of time provides smooth, long-term benefit and keeps shares outstanding
  - However, there are transaction costs and administrative complexities that must be understood
  - May be dilutive, can be overused

Loan Stretch-Outs

- Refinancing an existing internal loan
  - Reduces annual principal and interest requirement
  - Stretches out share allocation, in turn:
    - Reducing annual benefit level
    - Reducing future ESOP RO
    - Creating pool of shares for future participants
  - Requires negotiations with ESOP Trustee

Planning for ESOP Sustainability

- An ESOP Sustainability Study involves forecasting ESOP RO, then integrating the forecast into the company’s financial forecast. This provides:
  - Assessment of whether there will be enough cash for the RO as well as other business needs
  - Robust projection of share value
  - Comprehensive comparison of alternatives
    - Impact on share value and cash flow
    - Outcomes for key stakeholders

To Sell or not to Sell…

- The Board of Directors has the ultimate decision.
- Usually Senior Management is involved in the decision.
- If solicitations to buy a company are received, usually the company President receives these types of inquiries.
- The President then gives this to the Board of Directors to review.
- The ESOP Trustees will also become involved since they represent the Trust.
  - If you have inside ESOP Trustees, it is suggested that you hire an Institutional Trustee for this transaction. (Many inside ESOP Trustees will not be able to make a fair and impartial judgment since they have an invested interest).

Conclusions

- The sooner you start thinking about ESOP sustainability, the better!
- The factors affecting sustainability will evolve as the ESOP matures
- Company management should be forecasting ESOP RO and integrating into a financial model
- The Board of Directors should be discussing ESOP sustainability, including methods for handling ESOP RO, at least annually, considering:
  - Cash requirements and effect on company and share value
  - Avoiding have vs. have-not issues
  - Maintaining a prudent distribution policy
- There is no universal “best” method – you need to define your objectives and analyze alternatives

Questions?

?

The California/Western States Chapter of The ESOP Association

Merri E. Ash

TI-TRUST
TRUE INTEGRITY FIDUCIARY SERVICES

Merri E. Ash
2415 Cambelback Rd
(610) 308-1886

merri.ash@ti-trust.com

Merri Ash, Senior Vice President at TI-TRUST, has over 40 years experience in Employee Benefits services. Merri's past work experience includes work as a senior trust officer with SunTrust Bank, Employee Benefits Consultant with Wyatt Company, Benefits Manager with Jonathon Corporation, an ESOP company and Team Leader and Senior Benefits Consultant with the National Automobile Dealers Association. She is a past Chairperson for the Administrative Advisory Committee of The ESOP Association, former Board of Governors member for the National ESOP Association and current Board of Trustees member for the Employee Ownership Foundation. Merri has been with TI-TRUST since 2002.

The California/Western States Chapter of The ESOP Association

Nancy Latu

Nancy Latu
Global HR Business Partner Manager
Chatsworth Products
(818) 735-6133
(805) 558-2944 Cell
nlatu@chatsworth.com

Nancy is the Global Human Resources Manager Business Partner at Chatsworth Products. She has been with the company for more than 24 years. She has full responsibility for the Human Resources function for all U.S. remote employees and all international employees. She was an internal ESOP plan administer working with the TPA and auditors by providing the data necessary for the ESOP Board of Trustees to make the necessary decisions. Nancy is a member of the California/Western States Chapter Steering Committee, serving as President in 2011-2012 and on the ESOP State Regional Chapter Council in 2012-2015. She is active with PIHRA (Professionals in Human Resources Association), serving on their Board of Directors for over 10 years.

CHATSWORTH PRODUCTS
An Employee-Owned Company

The California/Western States Chapter of The ESOP Association

ESOP Sustainability: Keeping it Going

CAWS Chapter Conference | South Lake Tahoe