The ESOP Association

Sustainability Throughout the ESOP Lifecycle

Multi-State ESOP Conference | Poconos, PA

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Tina DiCroce

Tina DiCroce, a Vice President at Chartwell, advises ESOP company management and boards of directors on how best to manage and fund their ESOPs for long-term sustainability. She is recognized nationally as a leader in repurchase obligation forecasting and helped develop sophisticated repurchase obligation models used by hundreds of ESOP companies. Throughout her career, Tina has worked with companies of all sizes in diverse industries across the country. Tina serves on the Fiduciary Advisory Committee of The ESOP Association and is a Chapter Officer for the Pennsylvania/Delaware Chapter of the Association. She has presented at several national and regional conferences over the years on the topics of ESOP repurchase obligation and sustainability and is known as an expert in her field.

Tina DiCroce
Vice President
Chartwell Financial Advisory
(215) 279-8558
tina.dicroce@chartwellfa.com

CHARTWELL

Merri Ash

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.

Merri Ash
Senior Vice President
TI-TRUST, Inc.
(610) 308-1886
merri.ash@ti-trust.com

TI-TRUST
TRUE INTEGRITY FIDUCIARY SERVICES

Robert Grossman

<BIO GOES HERE>

Robert Grossman
Title
Polsinelli
XXX XXX XXXX
Email

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

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**

Defining Sustainability

- Starts with overall structure of ESOP transaction
- First 5 to 10 years:
  - Paying off the ESOP transaction financing
- Years 10 – 15:
  - Repurchase obligation (“ESOP RO”) increases
  - Share price recovered from impact of debt load
- Years 15 – 20+:
  - Mature ESOP

Common Sustainability Concerns

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:
  - ESOP is heavily funded with dividends or S corp distributions (partially-owned S corp ESOP)
  - Short ESOP loan schedule, prepayments on ESOP loan
  - Long distribution delays / installment periods
  - ESOP RO handled with redemptions (more on this later)

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

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
    - <u>404 Deduction Limit (25% of qualified payroll):</u> Limits company's ability to contribute to other plans, requires supplemental funding strategy for ESOP
    - <u>415 Allocation Limit ($56,000 in 2019):</u> Limits individual participation in 401(k) and individual benefit in ESOP
    - <u>409(p) – Anti-Abuse Limits:</u> Too many shares allocated to too few people

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
    - *Note distinction between contributions used to fund ESOP loan payments & value of shares released from ESOP loan suspense*
  - Does not 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

Young ESOPs – *< 10 years*

Understanding the consequences of your ESOP structure and design

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 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

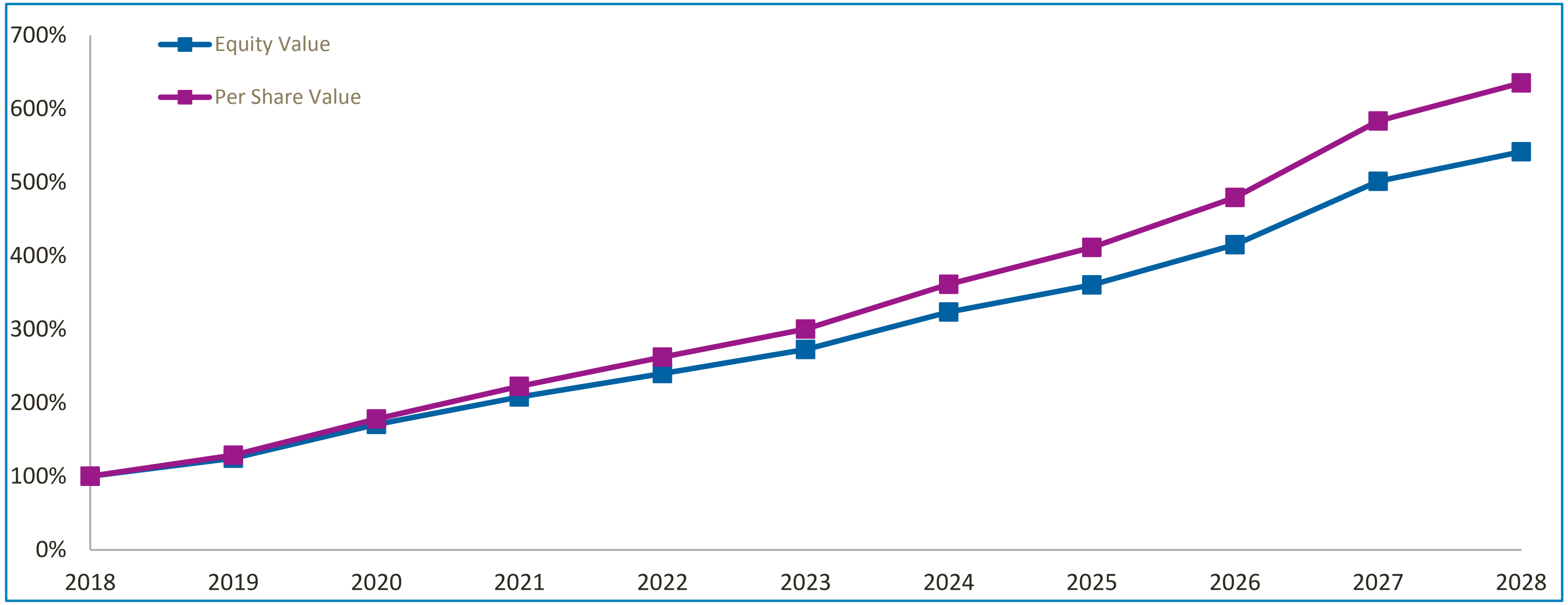
- 2 Ways to get cash into ESOP to recycle shares:
  - Contributions: Allocated pro rata to compensation
    - Provide a “benefit to participants”
    - Subject to 25% contribution limit
  - S Corporation Distributions: Allocated pro rata to shares
    - Provide “shareholder return”
    - Can concentrate 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



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

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

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?

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- Please complete the conference evaluation which will be sent immediately following conclusion of the conference via SurveyMonkey
- Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs