The ESOP Association

PLANNING FOR ESOP SUSTAINABILITY: A CASE STUDY

Indiana Chapter Annual Conference | Carmel, IN

March 5, 2020

Agenda

- Defining Sustainability
- Common Sustainability Concerns
- O'Neil & Associates
- Planning for Sustainability
- 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
- 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:
  - Short ESOP loan ("internal loan") schedule or prepayments on ESOP loan
    - Dictates period over which shares are allocated & what level of benefit is provided, impacts timing of ESOP RO
  - ESOP is heavily funded with dividends or S corporation distributions
    - Often an issue for partially-owned S corporation ESOPs
    - Dividends / S distributions on shares in participant accounts allocated based on shares
  - ESOP RO handled with redemptions
  - Long distribution delays / installment periods

Repurchase Obligation

- Be mindful that unexpected events (early retirements, deaths, higher-than-usual diversification elections) can occur
- Large ESOP RO may mean:
  - ESOP cash needs exceed Company cash flow, or limit ability to invest and grow
  - ESOP cash needs exceed IRS qualified plan limits
    - <u>404 (a) contribution limit (25% of qualified payroll):</u> Limits company's ability to contribute to other plans, may require supplemental funding strategy for ESOP
    - <u>415 (c) allocation limit ($57,000 in 2020):</u> Limits individual benefit
    - <u>409(p) anti-abuse limits:</u> Too many shares allocated to too few people

Repurchase Obligation

- Impact of Distribution Policy:
  - Immediate vs. delayed
    - Immediate accelerates future obligations / delayed increases value held by former employees
  - Lump sum vs. installments
    - Lump sum accelerates future obligations and creates year-to-year variability / installments slow down future obligations and produce a smoother obligation
  - Also need to consider diversification & in-service provisions

Repurchase Obligation

- Impact of repurchase method:
  - Recycling:
    - Company puts cash into ESOP to repurchase shares via contributions or dividends / S distributions
    - Shares are reallocated immediately to eligible participants
  - Redeeming:
    - Shares are purchased by company and leave ESOP
    - Shares can be retired, recontributed, or sold back to ESOP in a "releveraging" transaction

Repurchase Obligation

- Releveraging:
  - Company sells some or all of the redeemed shares back to the ESOP in exchange for a term note ("internal loan")
  - Shares sold to ESOP are held in unallocated account, and are released to participant accounts as internal 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 reduces future ESOP RO, and provides smooth, long-term benefit to participants
  - *Note: releveraging is a transaction, with associated costs and complexities*

Managing Benefit Levels

- Benefit level = value allocated as % of qualified payroll
  - Managing benefit levels is easier if you don't have really high ESOP RO; sometimes high benefit levels are unavoidable
    - Largely dependent on value of equity relative to qualified payroll base
  - How quickly are you paying down your internal loan/releasing shares from loan suspense; how quickly repurchased shares are reallocated?
  - Don't want the "tail wagging the dog" – ESOP RO driving benefit levels
  - How you handle ESOP RO affects benefit levels
    - Distribution policy, redeem/recycle/releverage

A CASE STUDY: ONEIL

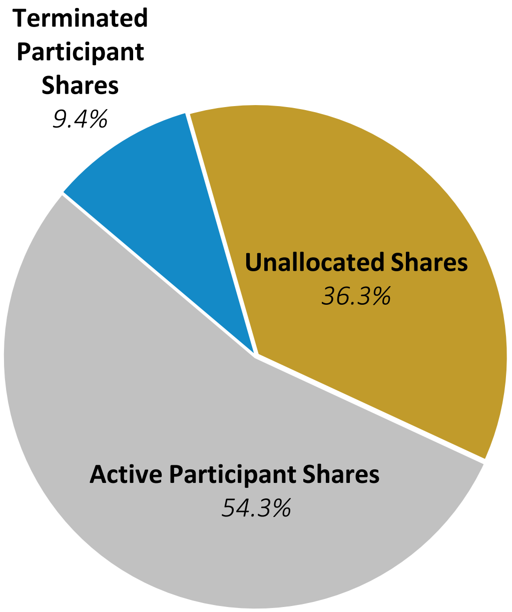
ONEIL

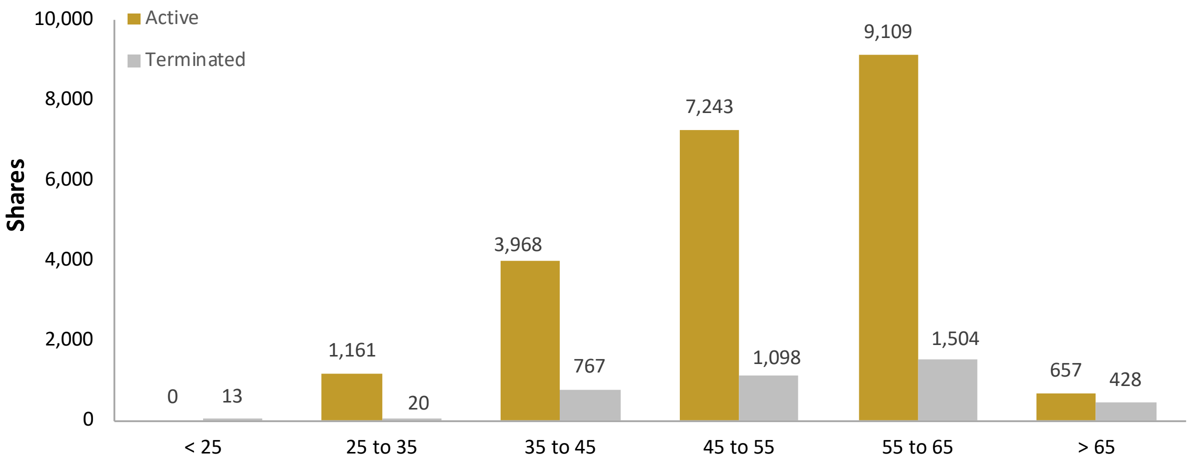
- Founded 1947
- Create, manage, and deliver product support information to the aerospace, commercial, and defense industries
- 100% ESOP-owned S Corporation
- About 250 employees
- ....
- ....
- ....

ONEIL

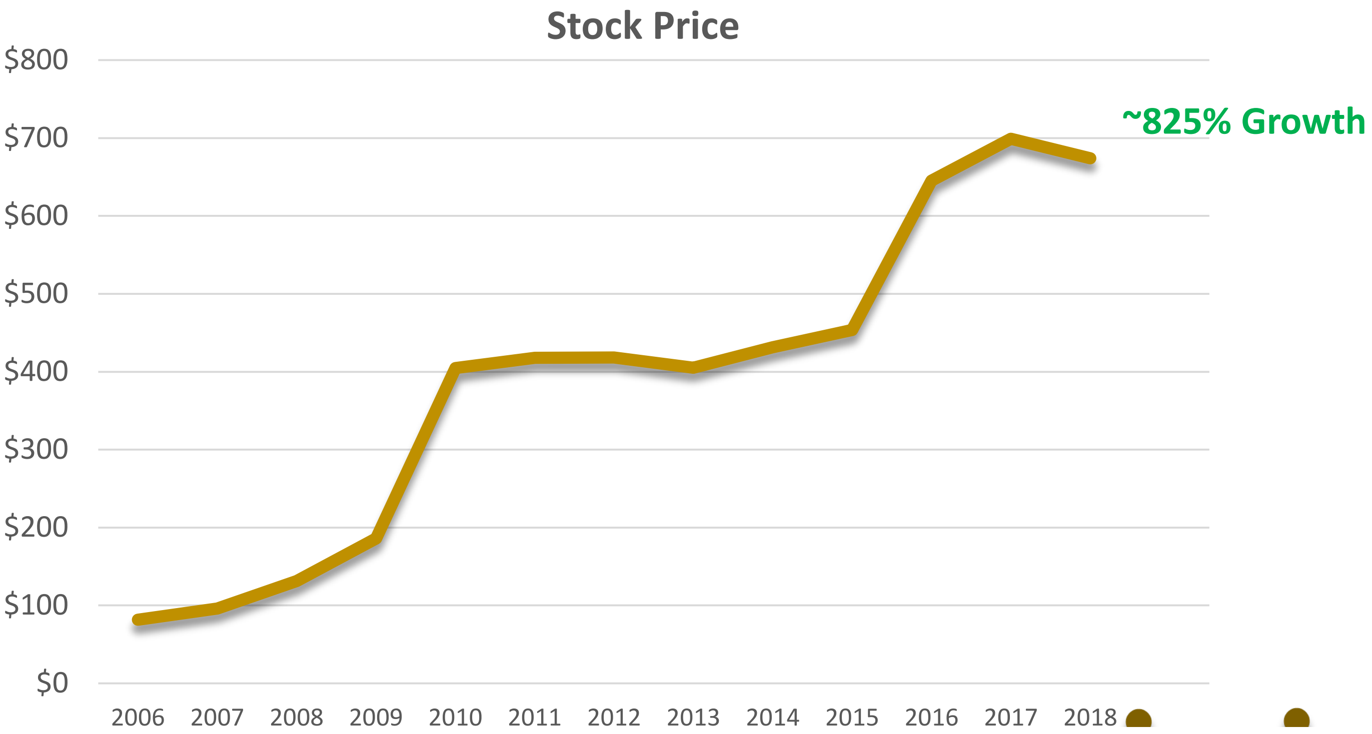
- ESOP formed in 2002, partial S corporation, paid S distributions
- 2015 – 2nd stage transaction to 100% ESOP (20-year ESOP loan)
- Approximately 250 participants in the plan, shares largely held by older employees closer to retirement age
- Fully segregate accounts following termination with annual cash contributions – repurchased shares recycled immediately in year following termination
- Bumping up against IRC 404(a) contribution limit
- Benefit levels have more-than-doubled with large ESOP RO

ONEIL


Terminated Participant Shares
9.4%
Unallocated Shares
36.3%
Active Participant Shares
54.3%


Active
Terminated
Shares
10,000
8,000
6,000
4,000
2,000
0
< 25
25 to 35
35 to 45
45 to 55
55 to 65
> 65
0
13
1,161
20
3,968
767
7,243
1,098
9,109
1,504
657
428

ONEIL


Stock Price
$800
$700
$600
$500
$400
$300
$200
$100
$0
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
~825% Growth

ONEIL

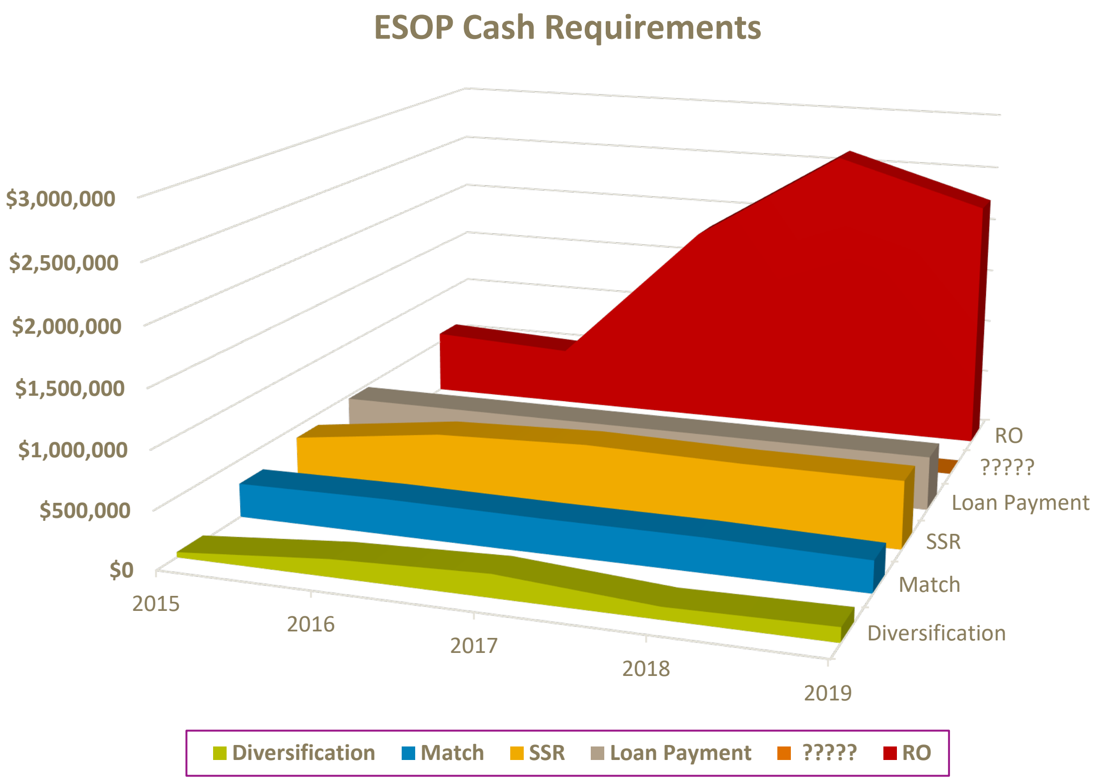
Phase I
- **ESOP Plan Created**
- 2004
- $81 per share

Phase II
- **ESOP Growth**
- 2004-2014
- Share price reaches $431

Phase III
- **ESOP Transaction**
- 2015
- Share price $435

Phase IV
- **ESOP Sustainability**
- 2017 – Retirement
- Share price $674

ONEIL



ESOP Cash Requirements
$3,000,000
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$0
2015
2016
2017
2018
2019
RO
?????
Loan Payment
SSR
Match
Diversification
Diversification
Match
SSR
Loan Payment
?????
RO

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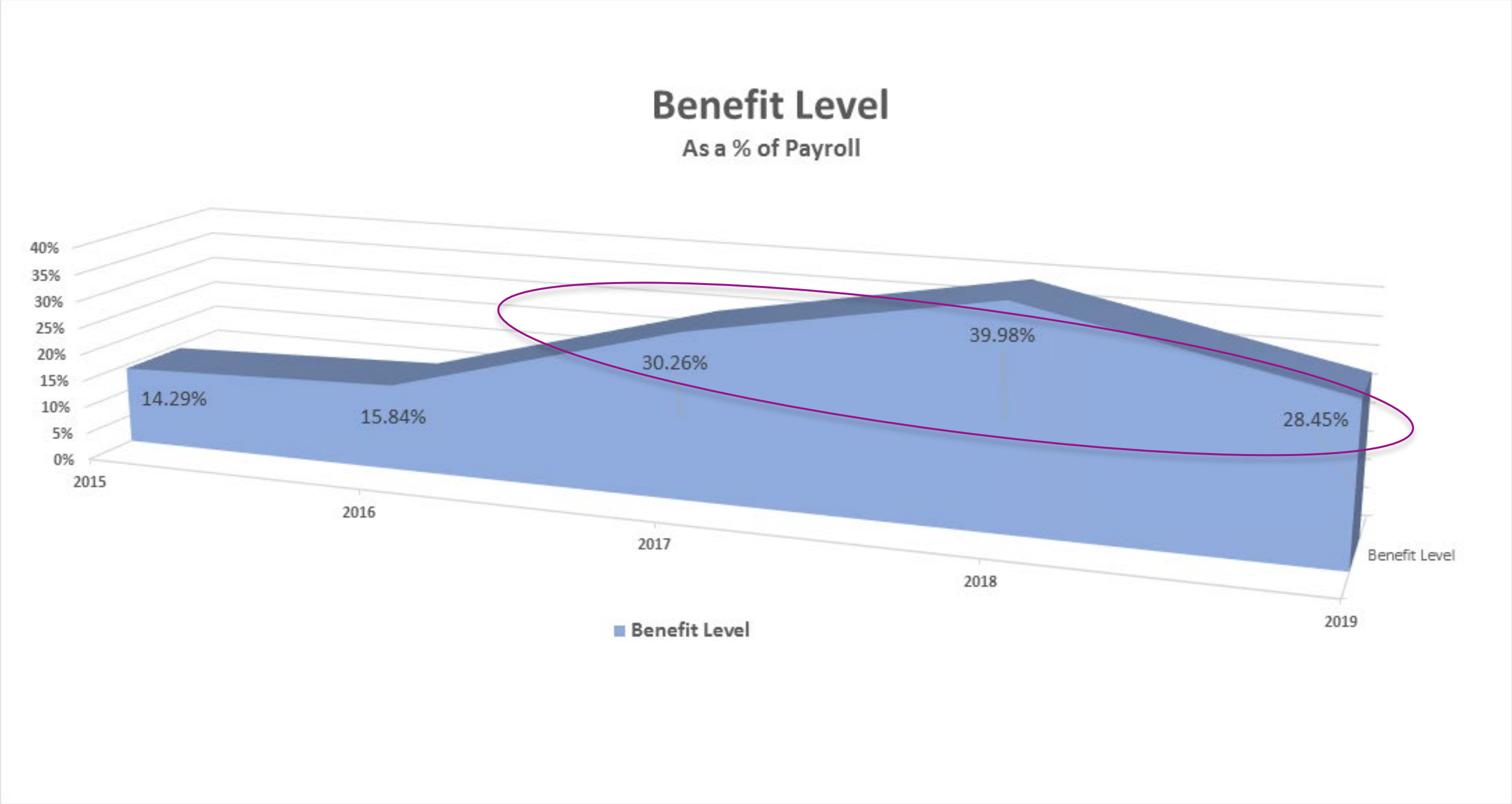

Benefit Level
As a % of Payroll
40%
35%
30%
25%
20%
15%
10%
5%
0%
14.29%
15.84%
30.26%
39.98%
28.45%
2015
2016
2017
2018
2019
Benefit Level
Benefit Level

Planning for Sustainability

Planning for Sustainability

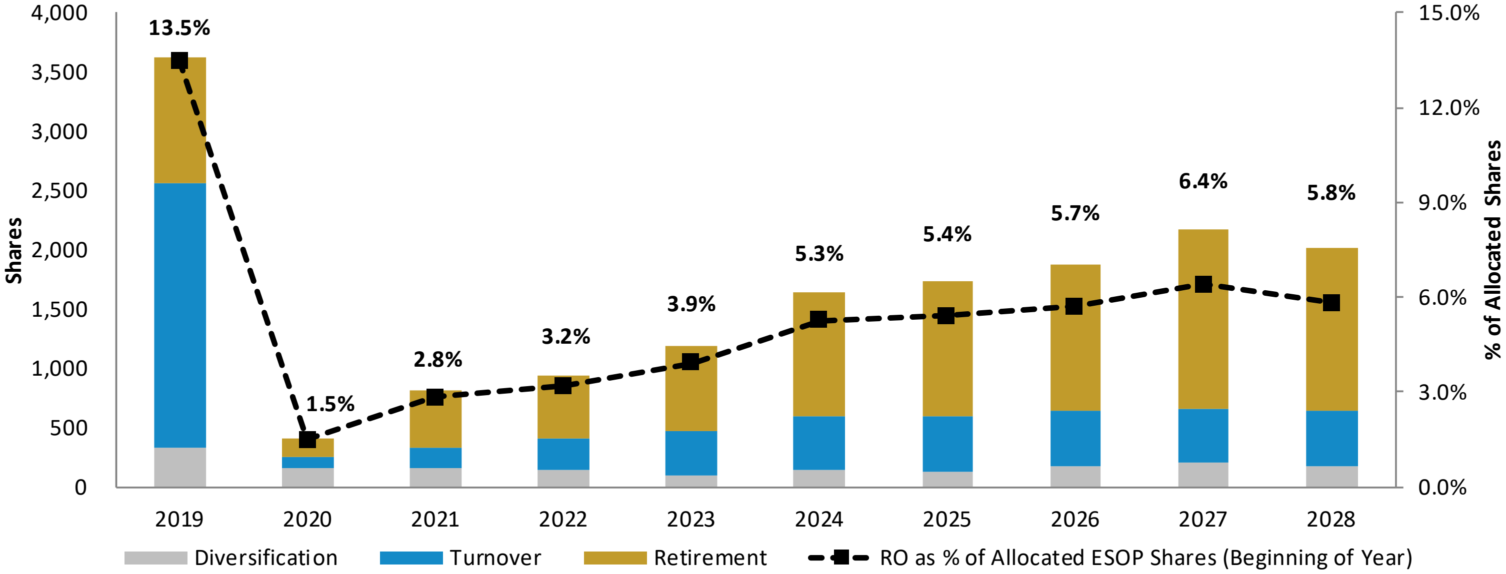
- It is so important to **plan ahead**!
- An ESOP Sustainability Study involves forecasting ESOP RO and integrating the forecast into the company's financial forecast. This provides:
  - Assessment of whether there will be enough cash for the RO as well as other business needs
  - Robust projection of share value
  - Comprehensive comparison of alternatives
    - Impact on share value and cash flow
    - Outcomes for key stakeholders
- Following the Sustainability Study, consider the following:
  - Establishing a capital reserve for future ESOP RO
  - What is the appropriate capital structure going forward?

Planning for Sustainability

- ONEIL's planning process
  - Annual repurchase obligation projections
  - Engage outside expert to prepare ten-year Sustainability Study, integrating repurchase obligation forecast into company financials
  - Consider plan design changes to manage future cash requirements and benefit levels

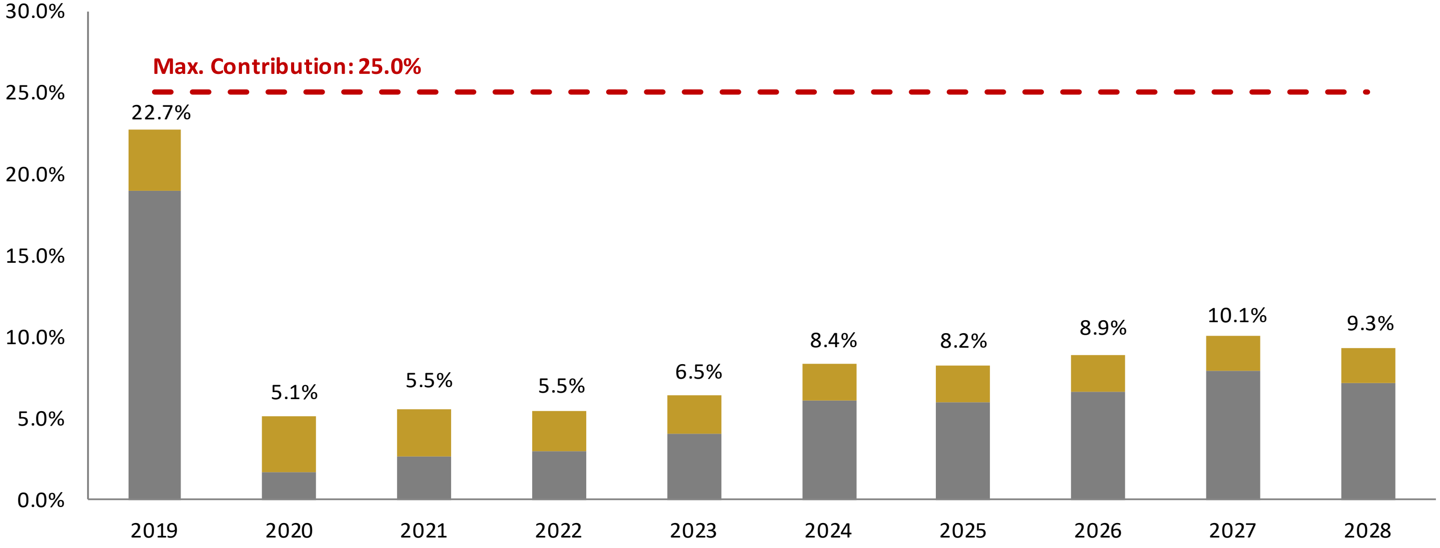
Planning for Sustainability

- Segregating in five installments → dramatic reduction in ESOP RO
- Plus, natural reduction due to lower projected turnover in future years



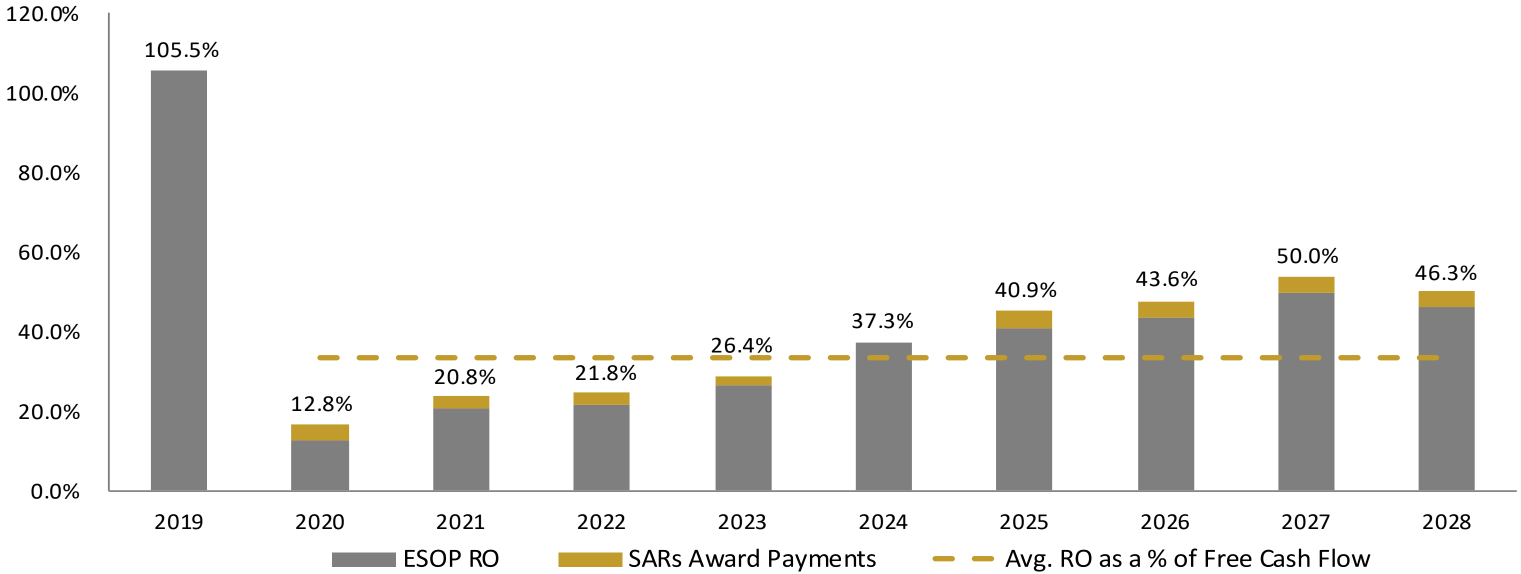
Planning for Sustainability

- No longer have to be concerned about exceeding IRC 404(a) limit



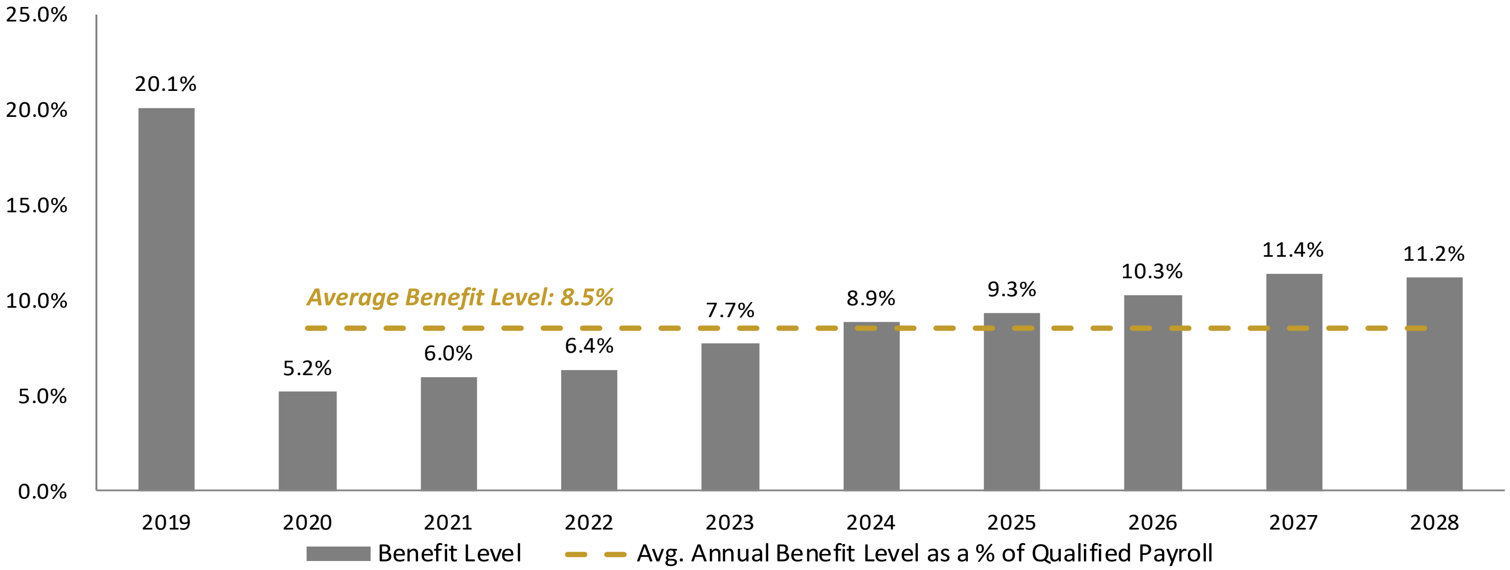
Planning for Sustainability

- Total equity-related capital claims are forecast to be reasonable, allowing the company to accumulate substantial cash reserves



Planning for Sustainability

- Benefit levels are forecast to be reasonable, averaging ~10% in the long term



Planning for Sustainability

- ONEIL Conclusions:
  - Changing segregation policy to convert accounts over 5 years vs. lump sum:
    - Creates a smoother cash requirement and benefit levels
    - Takes effect for those terminating in 2019 and beyond
  - Healthy percentage of shares to allocate in the future
  - ESOP RO appears manageable / affordable
  - Benefit levels are forecast at a reasonable level

Conclusions

- Company management should be forecasting ESOP RO and integrating into a financial model, *before* issues arise!
- 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
  - Haves vs. have-nots issues
  - Maintaining a prudent distribution policy
- There is no universal "best" method – you need to define your objectives and analyze alternatives

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.

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CHARTWELL

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Senior Vice President at TI-Trust, Inc., Kim currently serves as Trust Officer for approximately 65 ESOPs, the majority of which are closely held companies, and has worked on a number of ESOP Transactions. In addition, she serves as Trust Officer for a number of 401k Plans as well as Nonqualified Plans. Kim has been with TI-TRUST since 2001 with past experience in the investment and insurance sectors.

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Hernan Olivas

President & CEO Hernan H. Olivas has been with ONEIL for 17 years and has spent the past three in his current role. Prior to attaining his position, Hernan worked on the United States Army Tank-automotive Armaments Command (TACOM) Electronic Maintenance System (EMS) program beginning in 1996, advancing to the position of Program Manager in 2004. During his time as EMS PM, he oversaw the expansion of EMS from a few tactical vehicle platforms to more than 15 platforms, including combat, construction and material handling, as well as joint programs with the U.S. Navy and U.S. Marine Corp. During his previous role as Director of Sales and Marketing, ONEIL experienced significant growth in commercial business revenue and client baseline.

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