

Defining Sustainability



Jamie Zveitel Kwiatek



Dawn Goestenkers



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**

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 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

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**

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

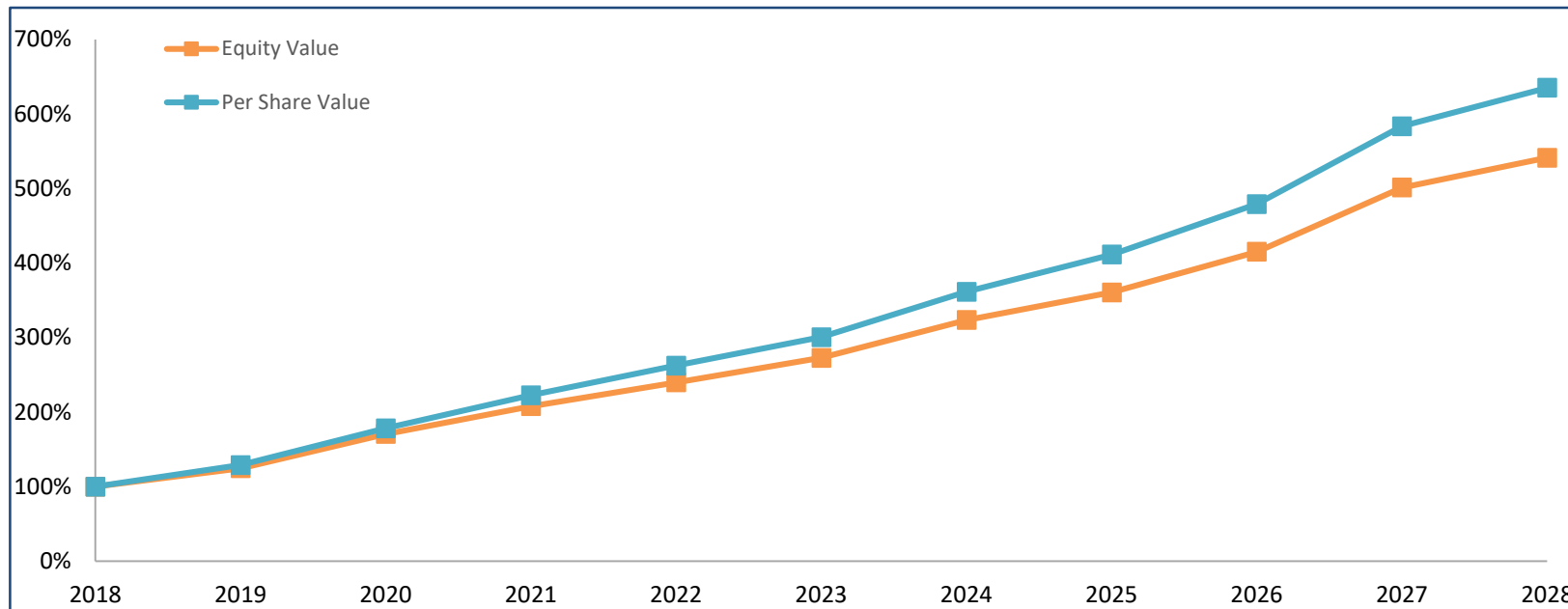
- 2 Ways to get cash into ESOP to recycle shares:
 - Contributions: Allocated pro rata to compensation
 - Provide a “benefit to participants”
 - Subject to 25% contribution limit
 - S Corporation Distributions: Allocated pro rata to shares
 - Provide “shareholder return”
 - Can concentrate shares in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

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 cash
 - 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

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Jamie Zveitel Kwiatek



Dawn Goestenkers



Jamie Zveitel Kwiatek



Polsinelli PC
D: (314) 889-7088
P: (314) 504-7588
jkwiatek@polsinelli.com



Jamie Zveitel Kwiatek makes your business her business. She helps employers traverse the quagmire of laws and regulations governing employee benefits and executive compensation. With more than 30 years of experience, she assists companies in the development and maintenance of creative employee benefit plans and executive compensation arrangements. She is also an advocate for clients when regulatory compliance issues arise. Jamie understands how important a productive workforce is to a client's business).

She has significant experience in the following areas:

- Design and administration of employee benefit plans and programs, including retirement and health and welfare plans
- IRS and DOL compliance programs
- Development of incentive and other executive compensation arrangements
- ESOPS, including ESOP transactions
- Advising clients regarding fiduciary responsibilities
- Design and implementation of stock and equity type benefit plans
- Negotiation with third party vendors and other parties regarding plan contract terms

Jamie is a frequent speaker on benefits and executive compensation matters and keeps up-to-date on the ever shifting benefits and compensation laws.

Dawn Goestenkers



Dawn Goestenkers brings vast experience and knowledge gained from more than 10 years in trustee services for employee stock ownership and qualified retirement plans. Dawn's past work experience includes commercial credit underwriting and lending. She has a concentration in plan administration and DOL regulatory issues, as well as deep ESOP transactional experience. Dawn is a member of The ESOP Association, Employee Owned S-Corporation of America (ESCA), National Center for Employee Ownership (NCEO) and frequently speaks on trustee and fiduciary topics. Dawn has been with TI-TRUST since 2007. BS Finance, Quincy University, MBA Southern Illinois University - Edwardsville.

Executive Vice President
Employee Benefits
TI-TRUST
D: (217) 221-8654
P: (217) 228-8060

