



The ESOP Association
California Western States
Annual Conference
October 11-13, 2017

Issues for Mature ESOPs

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Issues for Mature ESOPs

- Mature ESOP companies face a variety of specific issues which can lead management, the board of directors and/or ESOP trustees to re-evaluate ESOP plan provisions, assumptions, and operating philosophies to assure the company is achieving healthy, sustainable growth



Issues for Mature ESOPs

Employee Perspective

- High ESOP repurchase obligation (RO) / Unsustainable cash flow requirements
- Too much stock held by terminated
- "Have vs. Have-not"
- All ESOP shares are allocated



Issues for Mature ESOPs

Management Perspective

- Qualified plan limits preventing higher compensated employees from receiving the full benefits
- Senior management has turned over and new executives have a small equity stake relative
- Non-ESOP shareholders want liquidity
- Non-ESOP stakeholders (i.e., management) want more equity



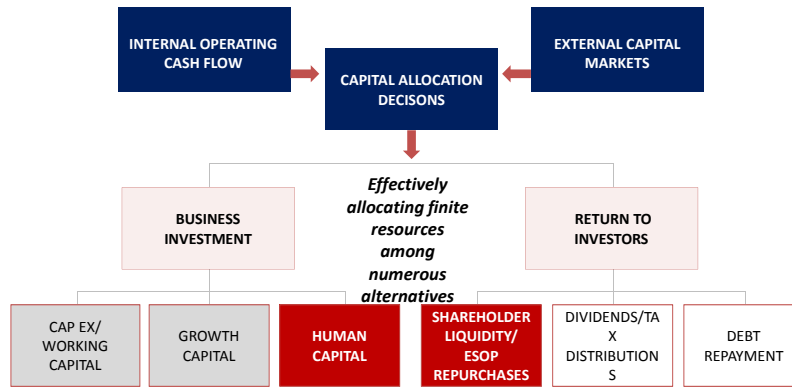
Issues for Mature ESOPs

Company Perspective

- Business conditions (i.e. market, industry) have changed since the ESOP was implemented
- Lack of benefit from ESOP relative to the repurchase obligation and enhanced risk and complexity
- Benefits are deemed too high or too low



ESOP Company Leadership's Dilemma



The Toolbox

Corporate Actions

- Implement a non-qualified plan
- Utilize third party financing to swap debt for equity
- Re-capitalization
- Complete acquisitions to expand payroll base and future growth prospects
- Divest business units to unlock capital and enhance future returns
- Delay/accelerate capital investments
- Sell Company



The Toolbox

Plan Operational Changes

- Modify distribution policies
- Modify diversification rights
- Modify allocation formula
- Dividends/distributions vs. contributions
- Stock contributions
- Freeze or Terminate the ESOP



Alternatives to Managing ESOP RO

- Recycle
- Redeem
- Releverage



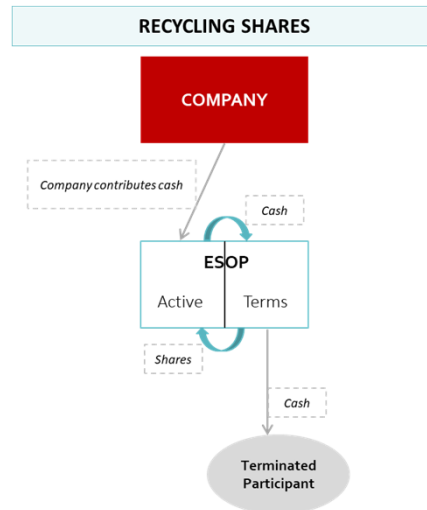
Alternatives to Managing ESOP RO

RECYCLE

- Cash in the ESOP is used to repurchase shares from terminated participants and reallocate them to remaining participants
- ESOP distributes cash to terminated participants
- Cash contributions, dividends/S distributions, or existing plan assets fund the purchases
- Participants' account balances are increased
- ESOP's ownership is unchanged
- Contributions are tax deductible
- Number of shares outstanding is unchanged



Alternatives to Managing ESOP RO



Alternatives to Managing ESOP RO

REDEEM

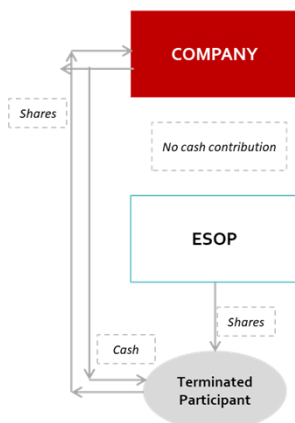
- ESOP distributes shares to terminated participants
- Company immediately buys back the shares
- No addition to participants' accounts
- The ESOP's ownership percentage decreases (if less than 100% ESOP-owned)
- If the number of shares outstanding is reduced, value per share increases
- Future share price growth accelerates
- No tax deduction for repurchase amount (may not matter for S Corp)



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Alternatives to Managing ESOP RO

REDEEMING SHARES



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Alternatives to Managing ESOP RO

RELEVERAGE

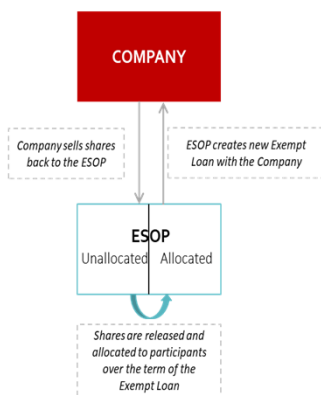
- ESOP distributes shares to terminated participants
- Company immediately buys back the shares
- Company sells newly issued shares to the ESOP
- New ESOP loan created and shares are allocated as the loan is repaid
- ESOP's ownership percentage can be maintained
- Shares available to new participants in future years



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Alternatives to Managing ESOP RO

RELEVERAGE TRANSACTION



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Case Study Overview

- **Company Overview:**
 - Smith Company has been a 100% ESOP owned S corporation since 1993
 - 2016 financial performance is below budget
- **Repurchase Obligation:**
 - Historically been 10 – 15% of compensation
 - The last two years repurchase near 25% of compensation
 - Expected to exceed 45% of compensation for at least the next two years
 - Some cash built up in ESOP in anticipation of large repurchase obligation
 - Currently recycles all repurchase obligation



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Proposed Alternative Scenarios

- **Scenario 1 - "Recycle All":**
 - Contributes up to 25% of qualified payroll and pays an S distribution sufficient to recycle all of the distributed shares within the ESOP
- **Scenario 2 - "Redeem All":**
 - Contributes up to 25% of qualified payroll and redeems all remaining repurchase obligation shares
- **Scenario 3 - "Releverage All":**
 - Contributes up to 25% of qualified payroll and redeems and releverages all remaining repurchase obligation shares



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Proposed Alternative Scenarios - continued

- Scenario 4 - “Actively Managed”:

General:

- Contributes up to 25% of qualified payroll
- Pays an S distribution of 1% of the previous year’s fair market equity value

Recycle Year:

- Use cash in the ESOP, cash contribution, and S distribution to recycle all of the repurchase obligation. Any excess cash can be used in the following year. If this isn’t enough cash, the Company will redeem any excess repurchase obligation.

Releverage Year:

- Company will accrue its cash contribution for the next year, and only the S distribution will be used to recycle shares. All the remaining repurchase obligation shares will be redeemed-and-releveraged.

Strategic Timeline:

- 2017 – Releverage
- 2020 – Releverage
- 2024 – Releverage
- Recycle all other years



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Analysis

- Scenario Current “Recycle All” Strategy:
- Repurchase Obligation:
 - Averages 42.3% of qualified payroll from FY 16 to FY 25
 - Averages 70.1% of free cash flow from FY 16 to FY 25
 - Declines in next 10 years as Company gets through current “bubble”
- “Actively Managed” Strategy Impact:
 - Lower the total repurchase obligation by \$4.9 million from FY 16 to FY 25
 - Total benefit level that averages 37.3% and is consistent and providing employees with confidence
 - Company’s cash balance \$3.2 million greater than the “Recycle All” scenario.
 - ESOP cash balance of \$1.8 million
 - 30.6% of shares are Unallocated providing a mixture of benefit to current and future employees, which is especially important over the ten years as repurchase obligation declines following the current “bubble”



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Final Considerations

Planning, Planning, Planning

- These situations can and will creep upon mature ESOPs if they are not forecasted and anticipated
- Planning tools exist, including Repurchase Obligation Studies
- Company and fiduciary advisors should be actively involved in the planning process



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Questions

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