

**OEOC**

**The 26th Annual Ohio Employee Ownership Conference**

*“Employee Ownership: A Better Way of Doing Business”*

# Best Practices for Integrating Projected ESOP Repurchase Obligations with Company Financials

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# Forecasting Repurchase Obligations

- Forecasting repurchase obligations is a critical part of the process of planning for future liquidity requirements.
- A repurchase obligation forecast and analysis (or “Study”, as it is usually called) is not just a set of numbers – it is a process that is intended to provide answers and potential solutions

# What is a Study?

- A repurchase obligation study is a *long-term projection* of ESOP distributions and the *associated cash requirements* that a company will face
  - AND
- An analysis of strategies for managing and funding the resulting obligations

# When is the right time to complete a Study?

- Do first study early in the life of the ESOP
- Review assumptions annually
- Update as necessary
  - Whenever there are material changes in your business or the Company's strategic plans
  - Assumptions or census change significantly
  - ESOP is considering transaction that will affect repurchase obligations
- Otherwise, update every 2 -3 years

# Do it yourself or hire a consultant?

- It depends on your resources and experience
- Doing it in-house...
  - You can run additional scenarios and update results more readily
  - Hands-on involvement may provide deeper understanding of RO issues
- A consultant brings...
  - Experience to the project
    - Reasonableness of assumptions
    - Data setup and review
    - Analytical experience
  - The ability to analyze the results and their implications for you
  - Using a consultant does NOT mean: “Here’s the data, call me when you are done”
    - ***Your input is critical to the process***

# The forecasting process

- Define issues and questions to be addressed by the Study
- Gather data
- Develop assumptions
- Model a “base case” forecast
- Analyze results & identify potential strategies for managing & funding the RO
- Model additional scenarios
- Develop conclusions & present results

# Defining the issues

- What questions are you trying to answer? For example:
  - How big are the repurchases and when will they occur?
  - Can we afford to meet the repurchase obligations and still grow the business?
  - Is the current funding strategy adequate?
  - What are the implications of the ESOP acquiring more shares?
  - What are the implications of amending the current distribution policy?

# Gathering data: What data will you need?

- Plan document, SPD, Amendments, Distribution Policy (if separate from Plan Document)
- Most recent allocation file
- Historical allocation files (to perform an analysis of historical turnover rates)
- Most recent valuation report
- Business plan/financial forecasts
- ESOP loan amortization schedule

# Factors/assumptions that affect repurchase obligations

- Plan provisions
- Demographics/actuarial assumptions
- Financial assumptions
- Repurchase method
- Funding strategy

*Some of these variables in turn are affected by the company's business and financial strategy and by exogenous variables (the economy, the industry, etc.)*

# Developing assumptions

- **Good assumptions are essential!**
  - Your projections will only be as good as the assumptions on which they are based
- Assumptions need to be:
  - Reasonable
  - Internally consistent
  - Consistent with other financial planning
- Get “buy-in” on the assumptions from key members of management

# Plan provisions

- Eligibility & Vesting rules
- Allocation method
- Accounting method/Rebalancing
- Distribution policy
- Account segregation
- Diversification rules
- In-Service distributions
- Retirement age(s)

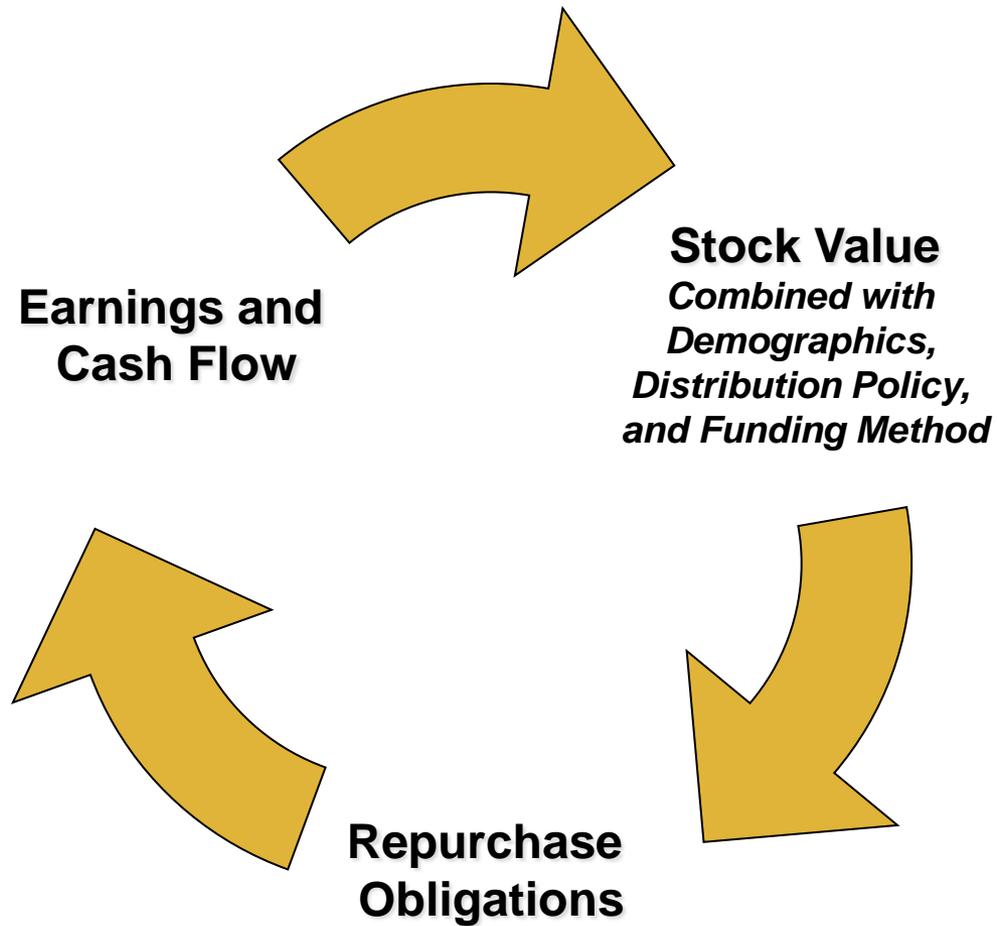
# Demographics/actuarial assumptions

- Age profile of existing population
  - Will drive timing of age-related events like diversification & retirements
- Turnover rates/patterns
- Death/disability
- Changes in size of workforce
- Salary Increases
- Age/compensation of future new hires
- Election rates of diversification rights

# Financial assumptions

- Stock value is a critical variable
  - Develop financial projections
  - Understand methodology used by your appraiser for valuing the ESOP shares and how repurchase obligations affect the value
  - Integrate the repurchase obligations into the financial model, use the resulting share value in the repurchase model
  - Adjust all related assumptions when adjusting growth assumptions

# Integrate repurchase obligations into the financial model



# Repurchase method

## **Redeeming**

- Company buys back shares
- No tax deduction – uses after-tax dollars
- No addition to participant accounts
- Reduces number of outstanding shares
- ESOP's ownership may be reduced

## **Recirculating**

- Trustee repurchases shares, shares reallocated
- Can use current contributions (tax deductible), S corp distributions, or accumulated cash balances
- Participants' account balances are increased
- Number of shares outstanding remains constant
- ESOP's ownership remains unchanged

# Funding strategy

- Pay-as-you-funding
- Pre-funding inside the ESOP
- Creating a cash reserve on balance sheet
- Issuing Debt (i.e., “Re-leveraging”)

# Model a “base case” forecast

- Input data into model and run forecast
- Check results for accuracy and reasonableness:
  - *Do the results make sense?*

# Analyze results/identify alternative strategies

- What are the answers to the questions that you initially identified?
- What other issues have emerged from the projections?
- Can repurchases be handled without interfering with growth?
- Should changes be considered in the plan or in distribution rules?
- What funding methods are appropriate?
- What is the best method for handling repurchases?

# Model additional scenarios

- Analysis of the “base case” scenario may suggest additional scenarios that explore any of the aforementioned changes
- You won’t necessarily be able to determine the impact of making changes without modeling out the alternatives
- In addition to modeling alternative strategies, you should model different financial assumptions (i.e., aggressive growth and low growth) to develop a range within which the repurchase obligations might fall

# Develop conclusions/present results

- What have you learned from the analysis?
- What are the pros and cons of the alternatives?
- Prepare a final report, including a “Board-friendly” summary of the findings, which usually includes:
  - Background information
  - Summary of the issues
  - Summary of the results and implications
  - Pros and cons of potential strategies
  - Recommendations and/or issues for further analysis
  - Also be sure to include details of financial model, repurchase obligations projections, and assumptions in your report

# Final words of wisdom

- Don't wait until the week before the board meeting to start the process – it takes time to do it right
- Developing good assumptions is critical – involve key members of management
- Understand how repurchase obligations are reflected in stock valuation & integrate into your financial model
- Stress test your strategy
- A Study is not just a set of numbers – it is an analysis of potential problems and solutions, and a tool to help you make decisions about how you will manage and fund the repurchase obligations
- Update your Study whenever 'meaningful' changes take place

# Defining Corporate Performance

- Performance Metrics
  - Income statement
    - Revenue or sales
    - Earnings
  - Balance sheet
    - Cash balance
    - Working capital
    - Debt
  - Cash flow statement
    - Cash flow from operations
  - Stock Price

# Defining Corporate Performance

- Why cash flow is important
  - Drives stock price growth
    - Higher cash balance
    - Finance acquisitions
    - Finance capital expenditures
    - Pay down debt
    - Stock redemptions
  - Shareholder returns
    - Dividends

# Repurchase Obligation – Corporate Performance

- Income statement
  - Depends on how repurchase obligation is accomplished
  - Contributions to the ESOP will lower earnings
    - From a valuation perspective – ESOP contributions may be adjusted to a normalized retirement benefit
- Balance sheet
  - Less cash or more debt depending on how repurchase obligation is financed

# Repurchase Obligation – Corporate Performance

- Valuation and stock price
  - Fair Market Value definition
  - Typical valuation:

$$\begin{array}{r} \text{Enterprise Value} \\ + \text{Cash} \\ - \text{Debt} \\ \hline \text{Equity Value} \\ - \text{DLOM} \\ \hline \text{FMV of Equity} \\ \text{Shares Outstanding} \\ \hline \text{FMV Per Share} \end{array}$$

# Repurchase Obligation – Corporate Performance

- Valuation and stock price
  - How is enterprise value (“EV”) determined
    - Income Approach
    - Market Approach
    - Asset Approach
  - Earnings
    - Drives EV
    - Normalize earnings (including ESOP contributions)
    - Ability to grow earnings given repurchase liability

# Repurchase Obligation – Corporate Performance

- Valuation and stock price
  - Balance sheet impact
    - Less cash or greater debt due to repurchase liability will drive equity value down
  - Stock price
    - Depends if shares are recycled or retired

# Repurchase Obligation – Corporate Performance

- Repurchase obligation methods
  - Contributions
    - Lower earnings due to ESOP contribution
    - Shares are recycled
    - Downward pressure on stock price
      - Cash leaves company; shares outstanding unchanged
  - Dividends
    - Earnings not affected
    - Shares are recycled
    - Downward pressure on stock price
      - Cash leaves company; shares outstanding unchanged

# Repurchase Obligation – Corporate Performance

- Repurchase obligation methods
  - Redemption
    - Does not affect earnings
    - Shares are retired
    - Share price – less shares outstanding will lead to higher stock prices overtime
  - Leveraged redemption
    - Earnings are lower due to future ESOP compensation expense
    - Shares are held in suspense and released as ESOP loan payments are made
    - Share price – higher cash balance due to lower repurchase obligation; offset by shares outstanding

# Repurchase Obligation – Corporate Performance

- Repurchase Obligation – Valuation Issues
  - Differing Opinions
    - Ability to honor vs. long-term valuation impact
    - Ignore repurchase obligation
      - FMV definition
      - Consistency with ESOP transaction
      - Assume sale of company – repurchase obligation goes away
    - Explicitly consider repurchase obligation
      - Reflected in earnings and cash flow projections
      - Reduction to enterprise value
      - Lower multiples / higher discount rate
      - How to project repurchase obligation

# Repurchase Obligation – Corporate Performance

- Repurchase Obligation – Valuation Issues
  - Ignore Repurchase Liability Example:

	12/31/2011	12/31/2012	12/31/2013
Enterprise Value	\$ 70,000	\$ 70,000	\$ 70,000
Cash	30,000	15,000	0
Debt	0	0	0
Equity Value	100,000	85,000	70,000
Shares Outstanding	1,000	1,000	1,000
FMV Per Share	\$ 100.00	\$ 85.00	\$ 70.00

# Repurchase Obligation – Corporate Performance

- Repurchase Obligation – Valuation Issues
  - Capture Repurchase Liability Example:

	<u>12/31/2011</u>	<u>12/31/2012</u>	<u>12/31/2013</u>
Enterprise Value	\$ 70,000	\$ 70,000	\$ 70,000
Cash	30,000	15,000	0
Repurchase Liability	(30,000)	(15,000)	0
Debt	0	0	0
Equity Value	<u>70,000</u>	<u>70,000</u>	<u>70,000</u>
Shares Outstanding	<u>1,000</u>	<u>1,000</u>	<u>1,000</u>
FMV Per Share	<u>\$ 70.00</u>	<u>\$ 70.00</u>	<u>\$ 70.00</u>

# Repurchase Obligation – Corporate Performance

- Repurchase Obligation – Valuation Issues
  - Transaction Example:

	Includes Repurchase Liability	Transaction Value
Enterprise Value	\$ 70,000	\$ 70,000
Cash	30,000	30,000
Repurchase Obligation	(30,000)	n/a
Debt	0	0
Equity Value	70,000	100,000
Shares Outstanding	1,000	1,000
FMV Per Share	\$ 70.00	\$ 100.00

# Concerns of the Trustee

- Is the board keeping abreast of the magnitude and timing of the company's repurchase liability?
- Has the board adopted an appropriate strategy for meeting repurchase liability?
- Does the valuation properly balance the effect of repurchase liability on the financial strength of the company with the right of participants and their beneficiaries to receive appropriate value for their account balances?

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