ESOP REPURCHASING STRATEGIES

There are many options to consider when determining the best way to handle an ESOP plan's repurchase obligation. Here's a refresher. **By Kevin T. Rusch**

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Privately held companies sponsoring an Employee Stock Ownership Plan (ESOP) have a financial responsibility to monitor and manage the cash flow required to maintain the ESOP. As plan participants are eligible for a distribution or diversification of shares from the ESOP, the company must provide a market to convert those shares into cash. This is known as the ESOP repurchase obligation.

HANDLING THE ESOP REPURCHASE OBLIGATION

The great thing about ESOPs is that a plan sponsor has many options to consider when determining the best path for handling their repurchase obligation. Common practices include recycling, redeeming or releveraging shares. Multiple options can be used at the same time and solutions will change as an ESOP matures, even within the first 10 years of its existence.

Recycling

Recycling shares is the most common approach to satisfying the ESOP repurchase obligation. The company satisfies the repurchase obligation by depositing cash into the plan. Recycling uses cash in the ESOP trust to convert participants out of their stock position at the time of distribution. Cash is generally deposited to the trust as a discretionary employer contribution or a dividend/S distribution on company stock held in the ESOP.

Participants receiving a cash distribution exchange their stock balance in return for cash with other participants in the plan. The other participants that exchanged their cash now have the shares allocated to their ESOP account. The net effect to the overall shares held in the trust is zero since *recycled shares do not leave the trust*.

Redeeming

Redeeming shares involves the company purchasing stock and retiring the shares. The company satisfies the repurchase obligation by paying cash to retire stock. In this process, *company stock does leave the ESOP trust* as a stock distribution to the former ESOP participant.

Generally, the steps are as follows:

1) ESOP distributes stock to plan participants.
2) Plan participants sign a "put" option to sell stock back to the company.
3) The redeemed shares are retired to the company's treasury account where they are no longer considered outstanding stock for valuation purposes.

One important item to note is the ESOP can also redeem the shares from the former ESOP participant to the extent the ESOP trust has available cash. While the company has the legal obligation to buy back the distributed shares, the ESOP trust can buy back the shares at the most recent fair market value on the company's behalf. This can be beneficial when a company wishes to retire some, but not all, of the stock being distributed.

The company can also redeem stock directly from the ESOP trust to get cash in the plan to process participant distributions. This involves additional costs, as an updated stock valuation on the date of the stock redemption is required by an independent appraiser.

Releveraging

Releveraging shares allows the shares to be repurchased by the ESOP trust. The company satisfies the repurchase obligation by paying cash to redeem shares, but instead of retiring the stock, the company sells the shares back to the ESOP in exchange for an internal loan. The shares purchased in the transaction are used as collateral for the ESOP loan and are *placed in an unallocated suspense account within the ESOP trust*. As the loan is paid off over time, the shares are released from the suspense account and allocated to the ESOP participants as a plan benefit.

The impacts of the three strategies are illustrated in the nearby table.

ESOP BENEFIT LEVEL

An important factor in deciding whether to recycle, redeem or releverage shares is to first determine what benefit level the company wants to provide to ESOP participants on

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	Recycle (Contributions)	Recycle (S Distribution)	Redeem	Releverage
Shares Outstanding	No impact	No impact	Reduced	No impact
ESOP Ownership	No impact	No impact	Reduced if < 100% ESOP	No impact
Add'l shares to EE accounts	Yes	Yes	No	Yes, over time
Employee group most benefitted	All employees (pro rata to comp)	Longer-term EEs with larger share balances	Longer-term EEs with larger share balances	All employees (pro rata to comp)
Per share value	Dilution	Dilution	No dilution	Dilution
Corporation's cash flow	Reduce	Reduce	Reduce	Reduce
Income tax deduction	Yes	No	No	Yes, over time

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an annual basis. The benefit level equals the summation of the fair market value of shares released from ESOP loan payments, cash or stock contributions, and reallocated forfeitures divided by eligible payroll. The benefit level is often communicated as a percent of eligible compensation. Once that value is known, the plan's distribution policy and repurchase obligation strategy can be modified as needed to assist the company in meeting its benefit level goals for the ESOP participants.

For example, if the desired benefit level is lower than the projected repurchase obligation in a given plan year, processing stock distributions would be a better solution for the company to achieve its desired benefit level. Instead of the ESOP covering the full repurchase obligation by recycling all the shares, the company can decide how many shares the ESOP would buy back in the case of stock distributions, with the company buying back the remaining shares and retiring them to the corporate treasury account. This approach reduces the benefit level and provides the company more control of how many shares are reallocated in the ESOP.

The release of shares from the ESOP internal loan also affects the benefit levels allocated to ESOP participants. Careful consideration should be given when drafting the terms of the loan documents, so they support the company's goals of appropriate retirement benefits to the ESOP participants.

REPURCHASE OBLIGATION FORECASTING

An analysis of the potential ESOP repurchase obligation should be done on a frequent basis to ensure that the company can meet the cash flow needs to operate and maintain the ESOP retirement plan. Plan consultants assist their clients by preparing repurchase obligation studies. Typically a 20-year forecast, this process provides the company guidance in determining the best strategy to deal with the ESOP repurchase obligation. In addition, these studies project future benefit levels provided to ESOP participants.

A thorough review and discussion of the following assumptions should be incorporated into the analysis:

- **Company value assumptions:** projected enterprise value, adjustments to enterprise value to compute equity value, and the number of shares outstanding to project future share price
- **Participant level assumptions:** projected retirements, participant turnover rates, mortality and disability rates, future eligible payroll for allocations and diversification election rates
- **Trust activity assumptions:** distribution policy, contributions to the plan, loan payments and share release, dividends/S distributions, rate of return on cash investments and redeeming, recycling, or releveraging shares

After the assumptions are determined and incorporated into the repurchase obligation software/modeling tool, the first scenario should be reviewed to determine if any assumptions need to be revised. Then multiple scenarios can be produced with different assumptions to see the impact on cash flow needs and benefit levels. Repurchase obligation scenarios are highly recommended for plan sponsors looking to change their distribution policy or releveraging their ESOP, since those changes can have a significant result on cash flow and benefit levels.

CONCLUSION

Repurchase obligation can be one of the largest cash flow requirements for an ESOP company. Understanding the available options to satisfy repurchase obligation can ensure the plan sponsor is using the appropriate strategy in the current life cycle of their ESOP. Working through a repurchase obligation study can not only educate a new or old ESOP company to understand the ins and outs of repurchase liability, but it also gives them a sense of comfort they have done their due diligence as a plan sponsor to ensure the sustainability of the ESOP and the current plan design is supporting their corporate goals. PC