Strategic Planning for Mature ESOPs

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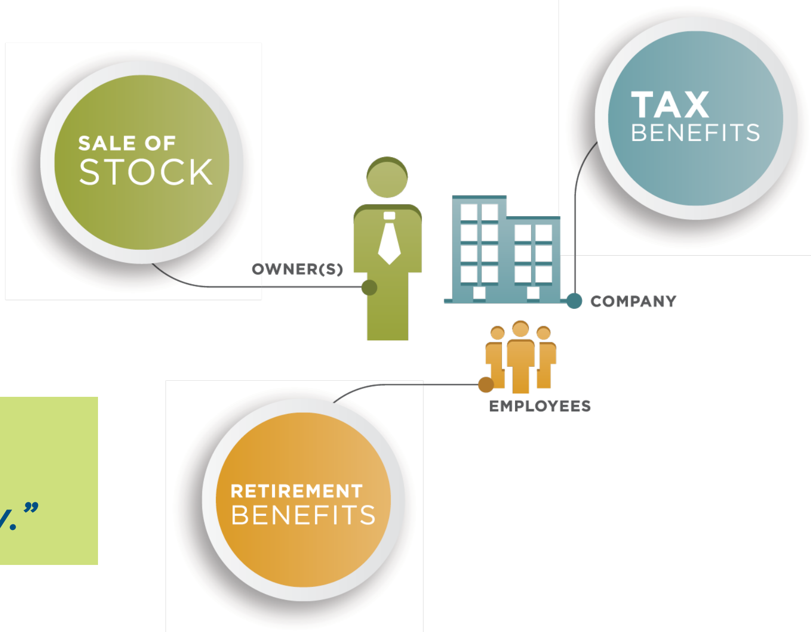
ESOPS IN THE US

DID YOU KNOW? *Nearly 7,000 US companies have an ESOP in place and 40% of those companies are 100% ESOP owned.



93% reported that establishing an ESOP was a "good business decision that helped the company."

As ESOPs mature in their ownership structure, board members need to carefully consider some of the possible courses of action available to them, including refinancing, grantor trusts, and even possible plan terminations.

The entire process requires strategic planning and policy implementation that allows the company to continue to deliver benefits AND have sufficient capital to meet growth objectives. ***There is no one-size-fits-all approach.***

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*Employee Ownership Foundation
Annual Economic Performance Survey

WHAT'S THE DURABILITY OF YOUR ESOP?

ESOP companies must identify value creation opportunities for equity shareholders and, as the company matures, it's important to assess the durability of their ownership structure considering strategic planning initiatives. In order to identify some of the most common challenges faced by mature ESOPs, there are ***three key indicators to consider:***

1

Capital Needs — When was the last time your company's balance sheet was analyzed given the short-term and long-term capital expenditures? Will ESOP repurchase obligations conflict with plans for growth?

2

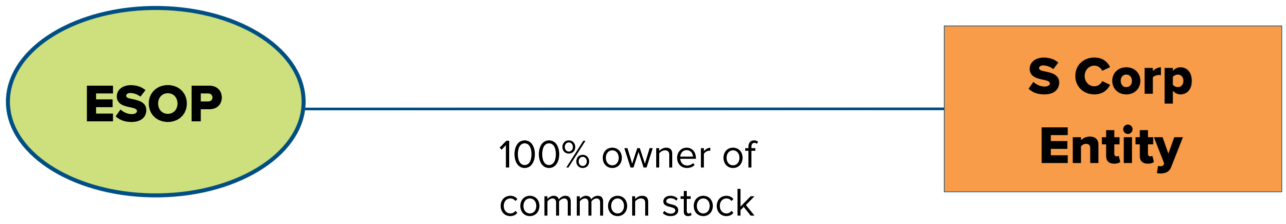
Management Incentives — Since the company became employee owned, have any major personnel changes occurred within the company's management team? Are the current leaders' interests aligned with the ESOP and the company's plans for growth?

3

Evolving Industry Dynamics — Have any major industry shifts impacted the company's business model and its ability to maintain or increase profitability?

CONSTRAINTS OF THE TRADITIONAL ESOP STRUCTURE

TRADITIONAL STRUCTURE



Attributes specific to the ESOP S Corporation structure, include:

- ❑ 409(p) limitations
- ❑ Management incentive plan (MIP) size restrictions
- ❑ Nondiscrimination of rewards and benefits
- ❑ Unproductive demands on capital
- ❑ 1 class of stock
- ❑ Eligible shareholder criteria
- ❑ Not accommodative to receiving outside growth capital (if desired)

COMMON ISSUES OF MATURE ESOP COMPANIES

- **Repurchase Obligation** — Demands on cash divert capital from productive to unproductive uses.

- **Lost Growth Opportunities** — ESOP structures can create an aversion to taking growth-related risks.

- **Access to Capital** — ESOP-related obligations can limit the ability to attract third party growth capital, particularly institutional equity.

- **Misalignment of Incentives** — The evolution of employee base demographics can result in the misalignment of rewards relative to value creation.

- **Management Succession** — The use of equity, beyond the ESOP, to attract and retain the next generation of leaders can be cumbersome with an ESOP.

COMMON GOALS OF MATURE ESOP COMPANIES

KEY GOALS	
Improve capital structure in support of business strategies	Restructuring of operating or legal entities, change ownership structure
Address repurchase obligation constraints on business objectives	Modify ESOP admin policies, pre-fund RO, balance sheet strategies, ESOP re-leveraging transaction, sale of company, recapitalization/restructuring of company
Provide flexibility and increase breadth of tools used to attract and retain key talent	Synthetic equity programs, authentic equity, compensation programs, ESOP re-leveraging
Provide meaningful incentive to key leaders	Special bonus, stock ownership, synthetic equity, forgivable loans
Overall better alignment of incentives with performance	Performance vs. retention-based programs, 409(A) plans
Effectuate an environment and culture that fosters entrepreneurialism in support of business strategies	Compensation programs, profit sharing, 409(A) plans, HR strategies
Optimize cash flows and growth profile	Tax strategies, repurchase obligation strategies, organic growth and non-organic growth initiatives
Improve ability to tap a broader segment of the debt and equity capital markets	Balance sheet strategies, ESOP admin policy revisions, growth profile enhancements

METHODS TO ENSURE THE LONG-TERM SUSTAINABILITY OF YOUR ESOP

Succession planning is a key element of a mature ESOP company.

- Determine process to implement executive compensation
  - Compensation Committee of the Board of Directors
  - New Equity for Key Employees
  - Deferred Compensation Programs: examination of benefit levels with ESOP to determine what additional is necessary
  - Annual Bonus Programs
  - Employment Agreements
- Succession/Future Leadership Committee of the Board of Directors

Integrating the next generation into the decision-making process.

- Plan administrative functions
  - Appoint "younger" individuals on this committee
  - Assist in assessing repurchase obligations
- Assist in board planning
  - Establish board packet
  - Assist in development of forecasts
- Assist in trustee monitoring and selection
  - Familiarize with the steps to select and oversee the trustee as well as the benefit payment process

COMPARISON OF COMMONLY CONSIDERED ALTERNATIVES

	CONSIDERATIONS	
MAINTAIN STATUS QUO	▪ Does not require reaching agreement on value with third parties ▪ No disclosure of proprietary data to third parties ▪ Retain 100% of ownership ▪ Some stability for employees and community ▪ Maintain operating control	▪ Significant repurchase obligations ▪ Operational difficulties associated with ESOP ownership ▪ Limited upside in light of changing competitive dynamics and industry outlook ▪ Does not address risks to shareholder value from competitive threats ▪ Accumulated employee wealth at risk ▪ Ability to preserve status quo in light of financial performance and competitive threats
SALE OF COMPANY	▪ Maximum upfront capital ▪ Locks-in valuation, not subject to risk of future performance / industry cyclicality ▪ Opportunity for employees to diversify wealth and reduce risk exposure to market ▪ Eliminates repurchase obligation issues	▪ Disclosure of proprietary info in a competitive environment ▪ Universe of buyers and their motivations ▪ Operating business continuity ▪ Operating control ▪ Employee continuity
RECAP	▪ Ongoing employee ownership of stock ▪ Maintain operating control ▪ Ability to provide upfront capital that can be used to diversify a portion of employee wealth in ESOP ▪ Ability to pre-fund a portion of repurchase obligations ▪ Little or no disclosure of proprietary data ▪ Can help effectuate change	▪ Size and construct of special diversification offering ▪ Availability of capital ▪ Complexities involved in building a durable structure while maintaining ESOP ▪ Internal market construct ▪ Appropriate relative ownership of ESOP and individual partners ▪ Growth objectives support

DO YOU HAVE A MATURE ESOP?

Address the following question before proceeding…

Is the company managed under a premise to "not lose money" in order to preserve ESOP account balances?
How do we create a structure that enables us to take advantage of growth opportunities (domestic and global)?
Is the company's board of directors positioned to recognize the company's position as the operating environment changes?
Does our ESOP ownership structure accommodate required change?
Does our ESOP ownership drive strategy or benefit from it?
Do I have to choose between meeting my repurchase obligations or reinvesting into the future success of the business, but not both?

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Interested in learning more about mature ESOPs?

READ ONE OF OUR BLOGS BELOW

- What's the durability of your ESOP?
- Repurchase Obligations in the Context of Corporate Finance
- Benefits of Recapitalization for Business Owners
- When should an ESOP-owned company pursue a recapitalization?

We can help refresh your ESOP - Let's chat!