Should You Releverage Your ESOP?

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Chapter 7

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As discussed in previous chapters (especially chapter 5), there are three ways of handling the ESOP repurchase obligation: (1) recycling, (2) redeeming, and (3) releveraging. Recycling and redeeming are the most commonly used strategies. This chapter compares and contrasts the three methods and addresses the circumstances under which releveraging may be a viable strategy.

The Three Rs: A Brief Overview

Recycling

Recycling is the exchange of cash for the shares subject to repurchase within the ESOP. Those repurchased shares are then "recycled" within the ESOP as the shares are allocated within the ESOP to those participants whose cash was used to purchase them. Since the shares are purchased from the participant, the distribution to the participant is made in cash. Recycling keeps the same number of shares outstanding and keeps the same number of shares allocated to participants within the ESOP. (See figure 7-1.)

Redeeming

Redeeming can occur either when the company redeems the stock that has been distributed to an ESOP participant, or when it redeems shares directly from the ESOP. The redeemed shares are then either retired or put into treasury depending upon state law. Redeeming reduces the total shares in the ESOP and the total number of shares outstanding.

When the company redeems shares that have been distributed to a participant by the ESOP, it is done so at the share price from the most

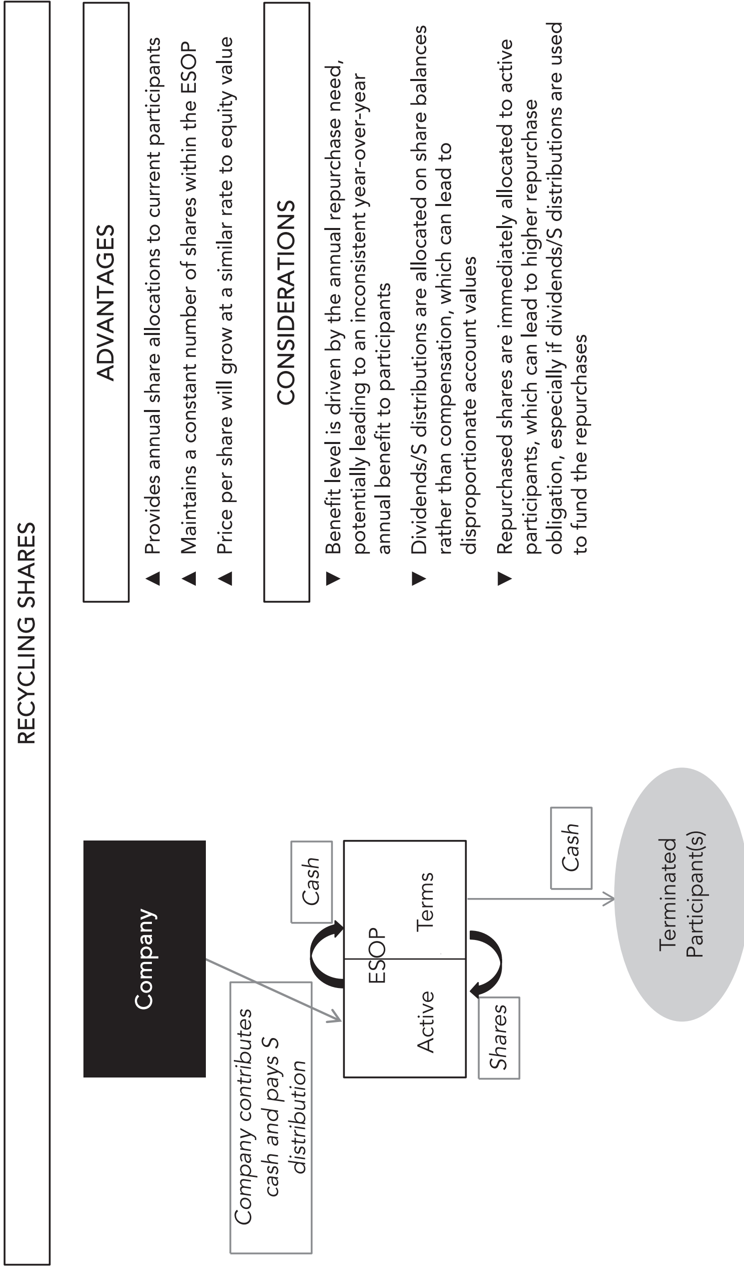

Figure 7-1. Recycling

recent valuation. When the company redeems shares directly from the ESOP, the ESOP must receive a value that is at least as great as the fair market value on the day of the sale. (See figure 7-2.)

Releveraging

In releveraging, the company redeems shares from the participant or the ESOP and sells some or all those shares back to the ESOP in exchange for a promissory note. These shares are initially held in suspense within the ESOP and released to the participants as the promissory note is paid. While releveraging keeps the same number of shares outstanding, all the shares are not immediately allocated to active participants. This allows the ESOP to "stretch out" the allocation of shares to participants over the term of the promissory note, typically over a 20- to 40-year time frame.

To assure the ESOP trustee that it is not paying more than the fair market value on the date of the sale, the ESOP trustee often requires a fairness opinion to be rendered. If the transaction occurs at a time other than the ordinary fiscal year-end, an additional valuation may be required. To avoid going through a full second valuation mid-year, ESOP companies will often make an administrative loan to the ESOP to cover distributions during the plan year. Then at year-end, the ESOP sells shares to the company to pay off the administrative loan and then do the releverage transaction. This may allow the appraiser to perform the due diligence for both the transaction valuation and the annual valuation at the same time, thus saving the company time and expense. (See figure 7-3.)

Which Method to Use; Considering the Effects on Stakeholders

In choosing between recycling, redeeming, and releveraging, it is helpful to first consider the group of stakeholders who may be affected by the alternate approaches.

The company's value and its cash flow is spread among the following groups of stakeholders:

- Active ESOP participants as employees (receive allocations based on compensation)

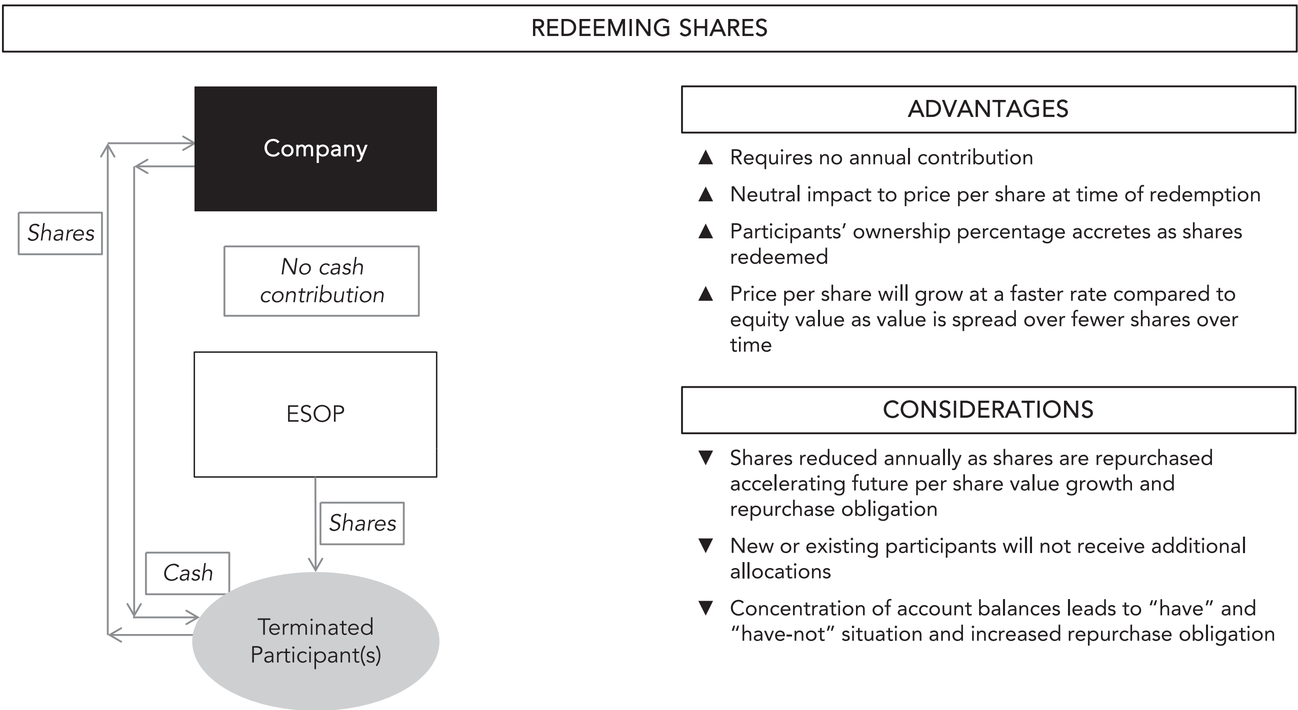

Figure 7-2. Redeeming

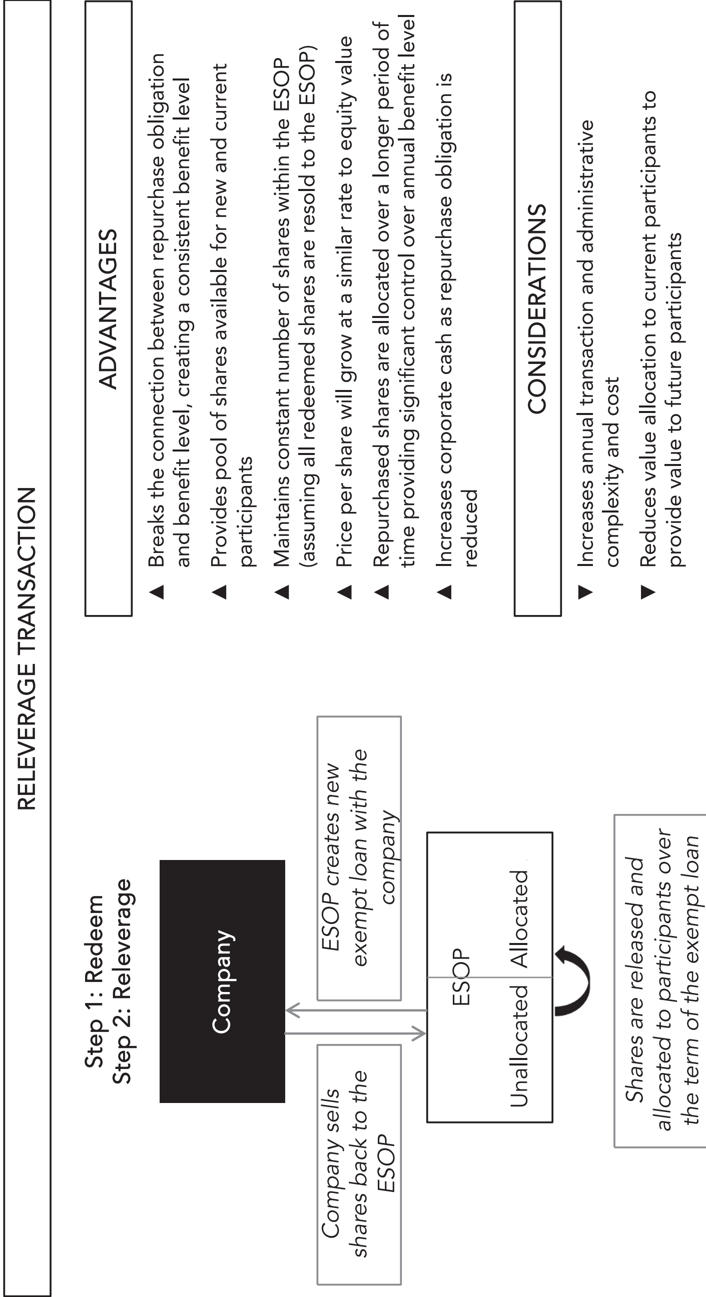

Figure 7-3. Releveraging

- ESOP participant shareholders (receive allocations based upon shares in the ESOP)
- Future ESOP participants
- Direct shareholders
- Synthetic equity holders

An individual often falls into multiple stakeholder groups. For example, an active employee who has met the eligibility requirements is an active ESOP participant as an employee. The same person may have some shares allocated to them in a prior year and is, therefore, an ESOP participant shareholder. If that same person stays employed for a future year, the person is also a future ESOP participant. And in some cases, most often at the executive level, that same person may also be a direct shareholder and/or a synthetic equity holder.

Some companies may not have each of these categories of stakeholders. For example, companies that are 100% ESOP-owned do not have any other direct shareholders. However, many ESOP companies, even 100% ESOP-owned companies, have synthetic equity holders who hold options, phantom shares, or stock appreciation rights (SARs).

In determining which method to choose in managing the repurchase obligation, the company's management and the board of directors have the responsibility of balancing the different interests of all the company's respective stakeholders. Active ESOP participants prefer large contributions. ESOP participant shareholders with large account balances prefer dividends or redemptions that will drive up share value. Direct shareholders and synthetic equity shareholders prefer redemptions that reduce the ESOP holdings and drive up their ownership percentage. The impacts of each method on each group must be considered in determining the right balance for the company (see table 7-1).

Considerations When Recycling

Who Benefits

Recycling requires the ESOP to have enough cash to cover the repurchase obligation. The source of the cash determines who benefits from recycling. The cash can come from current-year contributions, current-year S distributions or dividends, or prior-year contributions or

Table 7-1. Potential impact on each entity or group

Stakeholder	Areas of Potential Impact
Active ESOP participants as employees	Benefit level (amount allocated on compensation or match as provided by the plan)
ESOP participant shareholders	Dividends plus share value growth
Future ESOP participants	Percentage of stock being accumulated in unallocated account
Direct shareholders	Dividends, plus share value growth; percentage of ownership
Synthetic equity holders	Dividends, plus share value growth; percentage of ownership
Company	Cash balance, change in equity value
Trustee	Value of ESOP trust; value of ESOP trust plus distributions; change in equity value

dividends that have accumulated in participants' accounts. If the cash used comes from current-year contributions, the recycled shares are allocated based upon current compensation or as a match of current deferrals as determined by plan provisions. Contributions benefit active ESOP participant shareholders. If the cash comes from S distributions or dividends, the recycled shares are allocated according to share balances benefiting ESOP participant shareholders. If the cash comes from prior contributions or dividends, the recycled shares are allocated on cash balances benefiting active ESOP participants or ESOP participant shareholders from prior years who are still in the plan.

Impact on Repurchase Obligation and Cash Flow

The source of cash used in recycling has a dramatic impact on repurchase obligation and, therefore, the company cash flow over time. If the cash comes from current- or prior-year dividends, the shares are allocated based on share balances, which tends to be more weighted to older participants who are closer to retirement. Since these participants are closer to retirement, their shares will be repurchased sooner, increasing repurchase obligations and reducing company cash flow. If the cash used in recycling comes from current-year contributions, the cash is spread based on compensation. Usually compensation of a total company is weighted toward younger participants, who will hold the

shares in their account for a long time. Since the repurchase obligation related to younger participants is spread over more years, the company has lower repurchase obligation and higher cash flow when it funds recycling with contributions. Unless a particular method creates greater tax savings or inspires employees to create more value, the total value created by the company is the same; it is simply allocated differently using a contribution versus a dividend.

Considerations When Redeeming

Who Benefits

Since redeemed shares are retired or added to treasury, future profits are divided among fewer shares. Therefore, redeeming benefits remaining shareholders, including ESOP participant shareholders, direct shareholders, and synthetic equity shareholders. Redeeming does not provide any benefit to active ESOP participants.

To provide a benefit to active ESOP participants, some companies combine redemptions with stock contributions to the ESOP. This combination separates the employee benefit from the repurchase obligation. This combination works well for companies whose repurchase obligation over time is similar to the stock contribution. However, when the repurchase obligation is more than the stock contribution, problems can arise.

First, as the number of shares redeemed exceeds the number of shares contributed, the total outstanding number of shares decreases, and the share price growth outpaces the company's equity value growth. Since the stock value growth isn't tied to company growth, participants can get the wrong message. Participants may think the company is succeeding because the stock price is increasing, but it may just be due to the reduction in the number of shares.

Second, when the share price outpaces equity growth, the repurchase obligation increases without a corresponding increase in the ability to pay for it. As stated earlier, redemption benefits shareholders. Older participants in the plan tend to hold more shares. As they are closer to retirement, the company will have to buy their shares sooner, increasing the repurchase obligation and reducing the company's cash flow without a corresponding increase in performance. Current retiring

shareholders receive more for their stock than they add to the value of the company. This is not sustainable in the long term. Eventually, future employees will have to pay for this benefit.

These issues caused by share price growth exceeding equity growth can be mitigated by releveraging some or all the redeemed shares.

Considerations When Releveraging

Who Benefits

Future ESOP participants, the ESOP trust, and the company all benefit from releveraging. Releveraging puts some or all the shares redeemed back into the plan subject to an internal loan. Since the shares are subject to an internal loan, the shares are not immediately reallocated; instead they are held in suspense to be allocated in future years. Therefore, releveraging benefits future ESOP participants. In companies that have direct shareholders or synthetic equity holders, the ESOP trust also benefits from releverage as it retains a higher percentage of the ownership and therefore a higher percentage of any future equity growth. Finally, since shares are held in suspense and not immediately allocated, the repurchase obligation is less than if those shares were immediately allocated to someone who may soon terminate or retire, benefiting the company.

The Need for a Dynamic Financial Model

Since the method chosen for addressing the repurchase obligation has such a variety of impacts on the various stakeholders, the best way to determine the best method for a company is to engage in an analysis using a dynamic model that involves a projection of the company's cash flow, a projection of the repurchase obligation, and a projection of the valuation. The analysis must incorporate all three. Different methods drive different repurchase obligation outcomes. The repurchase obligation affects cash flow and cash balances, which will affect valuation, which will in turn affect the repurchase obligation. The analysis will fall short if it doesn't integrate all three.

The analysis should consider each method as well as combinations of methods. For example, a scenario could be to recycle using a set contribution and a small dividend, and then redeem or releverage the excess if the excess is significant.

There will be different "winners" between the scenarios. In evaluating the results of the analysis, the company must first clarify its goals. The company should ask:

- What is the ownership objective? Is the company focused on building value for a sale to a third party, or does it need to balance the value given to each type of stakeholder to sustain the current ownership structure for the long haul?
- Is employee ownership just a benefit plan, or is it an integral component of the company's identity?
- What is the ideal return to provide to each group of stakeholders?

There are no right or wrong answers, but these are keys to determine the company's goals. With these goals in mind, the company should evaluate the following in each scenario:

- Company cash flow
- ESOP cash flow
- Benefit provided to each stakeholder group
- The benefits and risks to each strategy
- The costs to implement the strategy

If the ownership objective is sustainability, the company will need to balance the interests of the stakeholders. In some cases, the choices will be easy. In others, the choices will be complex. The most complex will often involve releveraging.

When Releveraging Makes Sense: Four Examples

Example 1: *The company can't afford its repurchase obligation. High repurchase obligations threaten the sustainability of the company.*

Company A had been able to handle its repurchase obligation as it continued to grow sales and profits. Meanwhile, the repurchase obligation had grown to 50% of compensation. The company recycled all the

repurchase obligation by contributing up to the maximum contribution limit (25% of compensation) and paying a dividend. This dividend had the impact of increasing repurchase obligations because a significant portion of the shares were held by a combination of terminated participants, participants that were eligible to retire, and participants who would be retiring in the next few years.

A change in the business market caused the company's sales to flatten for a few years. Early on, management continued to provide optimistic forecasts to the appraiser with concrete plans to respond to the market challenges with new technology and new markets. Therefore, the valuation stayed flat even though repurchase obligations started eating the company's cash reserves. However, the outside pressure on some existing lines continued to reduce sales, and overall profits and cash flow did not grow. The repurchase obligation was out of hand, and the company had to do something to change it.

This strategy provided a tremendous benefit to the active ESOP participants and to the ESOP participant shareholders and synthetic equity holders. The strategy was hurting future ESOP participants. Any shareholder who did not completely cash in was being hurt by a lower share price due to lower excess corporate cash.

Company A eliminated the dividend and cut the contribution. Annually, the company negotiated releveraging a substantial portion of the repurchase obligation. After several tough years, the company was able to weather the business challenges. The share price fell substantially over a few years due to a declining cash balance, but not as far as it would have fallen had Company A continued to recycle all of its repurchase obligation.

This company is not alone. I have seen several companies where the repurchase obligation is as high as 70% of compensation. While everything is going well, many of these companies have the cash flow to handle the high repurchase obligation; however, as just discussed, a flattening or dip in profits can really threaten these companies. A high repurchase obligation drains existing corporate cash, requiring the company to borrow to pay its obligations. In these cases, the company cannot afford to continue the high benefit it is giving to the active ESOP participants and ESOP shareholders. The current strategy of providing benefits to current employees and current shareholders will cause the

stock price to fall, hurting those employees who stay employed for a few years. Releveraging is needed to lower repurchase obligations to a level that no longer exceeds cash flow.

Example 2: *The company has a high repurchase obligation that it appears to be able to finance today, but in the long term, it cannot afford the repurchase obligation, especially if profits flatten or fall. By releveraging early and diversifying some of the active ESOP participants' stock, the company can find the balance for all stakeholders and sustain itself.*

Company B also had a high repurchase obligation, but acted early to prevent a similar result in the event of a business downturn. Company B had been redeeming all its repurchase obligation and contributing shares up to its desired benefit level of 10% of compensation. However, the repurchase obligation exceeded 60% of compensation for the next 10 years and would exceed 85% of compensation over the second 10 years. If the company continued down this path, it would redeem more than 76% of its shares over 20 years. At the same time, the company was still releasing shares from suspense related to earlier ESOP loans.

Assuming the business continues to grow, Company B had enough cash flow to continue this strategy for the next 10 years. However, the repurchase obligation in the next 10 years would exceed cash flow. This was not sustainable. The benefits were not balanced between its stakeholders. By redeeming so much stock, the company was providing a great stock growth for its ESOP participant shareholders and its synthetic equity holders, but not providing enough for its future ESOP participants.

So Company B negotiated with its outside trustee to redeem all of the shares currently held by terminated employees and about 5% of the shares held by active employees and releverage a portion of those shares back to the ESOP. The trustee negotiated a higher contribution to make sure the employees were receiving a minimum 14% stock contribution, and it extended the existing ESOP loan in the process, assuring benefits for future ESOP participants.

This transaction provided a better balance between the stakeholders. It enabled terminated participants to receive their distributions

earlier. The ESOP participant shareholders and synthetic equity holders continued to receive an increase in share value due to the current performance and the reduction in outstanding shares.

The active ESOP participants received a greater percentage of the growth because the terminated participants were no longer receiving the continued growth of the stock. The benefit level going to the active ESOP participants and the future ESOP participants was more than 35% of compensation. The active ESOP participants also received a small amount of diversification within the ESOP, so all of their investment was not tied to a single stock.

Future ESOP participants received a more consistent future benefit because the existing loan was extended, and they received a larger annual contribution.

Most importantly, the transaction reduced the company's repurchase obligation to a point that the company could afford its repurchase obligation without exceeding cash flow. This balanced approach is more sustainable for the company and its stakeholders.

Example 3: *Company C had a high repurchase obligation for about five to eight years and chose to manage its repurchase obligation by balancing the benefits to its stakeholders.*

Company C's repurchase obligation was very high because the company was going through a period of tremendous growth and there was a bubble of retirements for the next few years. At the same time, the ESOP was still leveraged for a few years. The existing leverage would be paid off at the same time as the repurchase obligation bubble was complete. The benefit level would drop from over 50% of compensation to 10% of compensation in the year the loan was paid off. Releveraging some shares now would provide shares that could be allocated after the existing loan was paid off and smooth the benefit level provided to employees.

This company chose a balanced approach using all three strategies. First, the company redeemed all of the shares from the current year's repurchase obligation and releveraged about 85% of those shares. The releverage provided a benefit to the future ESOP participants. By having a net redemption of part of the current shares, the ESOP shareholders and synthetic equity holders will benefit in the future

from value being spread among fewer shares. The company also made a 20% contribution in cash. Part of the contribution was used to make payments on the existing loan, which released shares from the loan to provide a more reasonable benefit (20% of compensation) to the active ESOP participants. The remaining cash contribution and a small dividend was held in cash to be used for the repurchase obligation next year.

The second year, the company made a similar contribution and dividend. The company was able to use the cash held from the prior year and the current year cash to pay for the repurchase obligation. If repurchase obligation continues as high for the next few years, the company may have to repeat this process.

Figure 7-4 shows how the company was able to use a combination of approaches and balance the benefits flowing to all stakeholders.

Example 4: *Releverage to keep majority stake.*

Releveraging may be needed to avoid dropping the ESOP into a minority position. The ESOP owns slightly more than 50% of the stock, and the company cannot contribute enough to recycle all the shares. Redeeming would drop the ESOP into being a minority shareholder and give a higher return to the direct shareholders and synthetic equity shareholders than to the ESOP. The company should consider releveraging to keep the ESOP above 50%.

When Releveraging Is Not Needed: Four Examples

Example 5: The repurchase obligation can be funded through normal contributions and dividends. Recycling makes the most sense.

Example 6: The repurchase obligation can be funded through normal contributions and dividends but is higher than normal for a year or two. The company should consider increasing contributions or dividends to fund the short-term spike or redeeming the excess shares and recontributing those shares in future years.

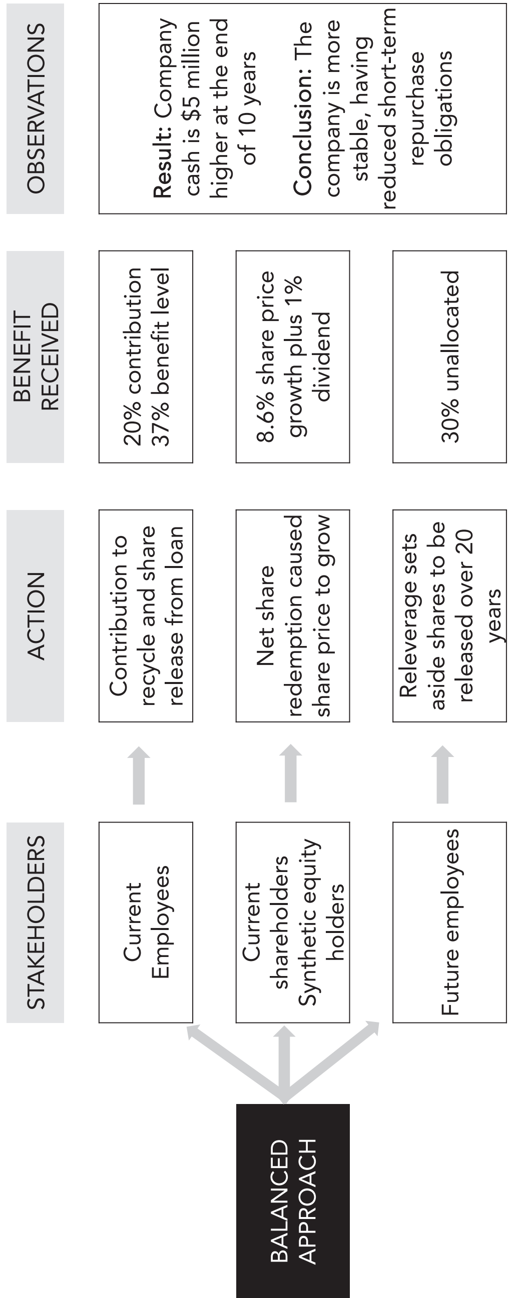

Figure 7-4

Example 7: In the case of a partially ESOP-owned S corporation, the S distributions that are necessary to enable shareholders to pay their share of tax on the S corporation may be sufficient to cover the cash needs of the ESOP. In these cases, the company should consider the amount of benefit that is being delivered as an employee benefit to active participants versus the benefit being delivered to ESOP participant shareholders. Where both are sufficient, recycling or redeeming combined with a stock contribution should be considered.

Example 8: Where the repurchase obligation and any release of shares from a prior ESOP loan is less than the desired benefit level, recycling may make the most sense.

Not Everyone Agrees When Releveraging Should Be Used

Some ESOP advisors believe that releveraging should be used only in rare cases such as to avoid going below 50% (as in example 4 above) or to avoid a Section 409(p) violation (i.e., of the S corporation anti-abuse rules). My understanding of their primary concern is they do not agree that the board should focus on all stakeholders. They believe the board's sole obligation is to increase the share price. They believe that 100% of the value of the company should be given annually to the current employees and shareholders. Therefore, any focus on future ESOP participants is unwarranted in their view.

However, as pointed out above, current ESOP shareholders may also be future ESOP participants. If the action designed to increase the share price in the short term limits the growth of the value in the long term because the company cannot afford future repurchase obligations, the action hurts current shareholders as well.

I agree that releveraging should not be taken lightly. However, I have seen cases where releveraging has saved the company from having to sell when the business is in a down cycle.

Other advisors are concerned about the ESOP buying stock when it already owns 100% of the shares. If the company has synthetic equity outstanding, the ESOP can purchase stock to avoid losing its percentage of total equity. In the rare case that the company has not issued any

synthetic equity, the trustee must look at the whole picture. If releveraging helps the company be sustainable and increases the ESOP equity value, and the active participants and ESOP participant shareholders get above-market returns, I believe releveraging is beneficial to the trust.

Conclusion

In managing a company's ESOP repurchase obligation, the company should consider the impacts of releveraging as well as recycling and redeeming. The ideal way to determine the best method for a company is to consider the company's objectives and engage in an analysis using a dynamic model that involves a projection of the company's cash flow, a projection of the repurchase obligation, and a projection of the valuation. Companies should first use recycling or redeeming if the company can accomplish its goals using these strategies. If not, releveraging should be considered. While more costly and complex, releveraging can produce the following results under the right circumstances:

- Provide benefits to current and future employees
- Reduce the repurchase obligation, which increases corporate net cash flow
- Increase equity return to the ESOP,
- Provide consistency between share value growth and equity growth to provide a clear link to employees between performance and their retirement value growth
- Sustain the current ownership structure

If sustaining the current ownership structure is your company's goal, releveraging may make sense.

About the Author

Tim Cleary is a managing director at Chartwell Financial Advisory, where he leads the ownership advisory practice, helping privately held and mature ESOP-owned businesses assess and respond to the challenge of driving healthy, sustainable growth. He has been assisting business owners and ESOP companies since 1987. Tim started his consulting career as a corporate tax and ESOP attorney. He then led Ernst & Young's national ESOP consulting practice. Most recently, Tim led Principal Financial Group's ESOP consulting practice, one of the largest ESOP administration and consulting practices in the country. Tim is an active member of the ESOP Association, the NCEO, and Employee-Owned S Corporations of America (ESCA).