Using the Three R's to Optimize Your ESOP

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2019

For a moment, imagine this: your company is contemplating a major capital expenditure which will have material impact on cash flow, debt capacity, growth, and even enterprise value. How much time and how much money would your leadership team spend analyzing alternative scenarios, funding strategies, and impact to share price? You would likely not act on your decision without adequate due diligence and perhaps counsel from your financial advisors. Now consider this: ESOP-owned companies spend millions each year to fund the repurchase of their employee-owned shares yet invest little time in analyzing the dynamic and often dramatic impact of alternative strategies. Understanding how to apply the fundamentals of recycling, redeeming, and releveraging shares is a must for the leadership of any ESOP-owned company.

First, some basic definitions:

Recycling

Cash in the ESOP is used to repurchase shares so that shares are immediately reallocated to remaining participants

Redeeming

Shares are distributed from the ESOP and repurchased by the company

Releveraging

Shares are redeemed, then sold back to the ESOP with an internal loan and the shares are allocated to participants over time as the loan is repaid

"Should we recycle, redeem, or releverage shares that need to be repurchased?"

The bottom line is that there is no quick answer—no one-size-fits-all solution. There are pros and cons associated with each method depending on the goals for the ESOP, and relative outcomes differ based on the circumstances. Nevertheless, this article defines the "Three R's" of repurchasing ESOP shares and explains how each strategy impacts employee benefits, shareholder returns, and the company's repurchase obligations.

Recycling

Recycling maintains the ESOP's ownership stake and ensures that all shares remain outstanding. Shares can be recycled with contributions (which are allocated pro rata to compensation) or with S distributions (which are allocated pro rata to share balance). Recycling is often the default repurchase strategy.

Recycling with Contributions

Recycling with Contributions reallocates shares to active employees based on each person's current compensation. The most efficient way to recycle shares is to contribute cash to the ESOP as needed, based on repurchase obligations and required internal loan payments. A potential disadvantage of this "pay-as-you-go" strategy is that the benefit level is driven by the repurchase obligation and may be inconsistent from year to year.

Alternatively, the company can make ongoing cash contributions based on a percentage of compensation, so that reserves accumulate in years of low repurchase obligations to be used in later years. This strategy provides a consistent annual benefit but can be "leaky"; any cash balance in a participant's account is distributed to the participant upon termination and therefore cannot be used for future repurchase obligations.

ESOP contributions are constrained by the IRC section 404(a) limit for deductible contributions. A company's contributions to qualified plans may not exceed a total of 25% of qualified payroll. If repurchase obligations exceed a company's target contribution level or the 25% limit, some repurchased shares can be recycled with S distributions or redeemed.

Recycling with S Distributions

Recycling with S Distributions reallocates shares to all ESOP participants (active and terminated) pro rata to share balance. As compared to contributions, S distributions have the advantage of not counting towards the 404(a) limit. However, they can be more expensive because S distributions must be paid equally on all outstanding shares, including any non-ESOP shares.

A company can control the ESOP benefit level by supplementing its desired contributions with S distributions. (Since S distributions are allocated based on existing balance, they are generally not considered a benefit to employees.)

However, S distributions often increase repurchase obligations by providing a relatively large allocation to the longest-tenured employees who are closest to retirement, thereby concentrating value in accounts that will soon be eligible for distribution. In extreme cases if the ESOP is funded heavily with S distributions, a have/have-not situation can develop or worsen and threaten the ownership culture.

Redeeming

Redeeming is a strategy in which repurchased shares leave the ESOP. Similar to recycling with S distributions, redeeming can be used to manage the benefit level when repurchase obligations exceed the desired contribution level or as a method of providing additional return to shareholders. After shares are redeemed, they can be retired to treasury, recontributed to the ESOP, or sold back to the ESOP.

Redeeming and Retiring

Redeeming and Retiring results in a reduced number of shares outstanding. Over time, a declining number of shares outstanding can result in per share value growing faster than equity value. This faster increase in per share value rewards shareholders pro rata to existing balance, which has a concentrating effect similar to recycling with S distributions.

It is a common misconception that redeeming and retiring shares reduces future repurchase obligations as compared

The Three R's: Relative Benefits to Key Stakeholders

● Highly favorable ◑ Somewhat favorable

	Recycle (Contributions)	Recycle (S Distributions)	Redeem (Retire)	Redeem (Recontribute)	Redeem (Releverage)
Employees	●			●	◑
Shareholders		●	●		
Company	◑			◑	●

to recycling with contributions. In reality, fewer shares will need to be repurchased, but at a higher value per share. The total cost may actually be higher when redeeming due to the concentration of value.

Another consideration relates to communicating performance. A large discrepancy between equity value growth and share value growth can create a challenge if employees equate share value growth with performance.

Redeeming and Recontributing

Redeeming and Recontributing has a similar effect on repurchase obligations and participants' account balances as recycling with contributions. Stock contributions are allocated to active participants in the same manner as cash contributions and are also subject to the 404(a) limit.

Many companies combine the previous two redeeming strategies by redeeming all repurchased shares, and then recontributing shares equal to a target contribution level and retiring the remainder. This strategy allows the company to control the benefit level and provide additional return to shareholders; however, to the extent shares are retired, the concentrating effect may increase repurchase obligations.

Redeeming and Releveraging

Redeeming and Releveraging reduces future repurchase obligations by shifting shares from participants' accounts into internal loan suspense. The shares are reallocated to participants' accounts over many years as the loan is repaid, instead of immediately using recycling. Since relatively fewer shares are held by participants, fewer shares need to be repurchased. Because unallocated shares are considered outstanding shares, share value growth remains in line with equity growth, as with recycling.

Releveraging can be used on a one-time or periodic basis to handle high repurchase obligations. It is most effective at reducing future repurchase obligations if a large number of shares are releveraged, and if the term of the resulting loan is sufficiently long, typically at least 20 to 30 years. However, as releveraging is an ESOP transaction, there are associated costs and administrative complexities which need to be considered. Additionally, there are negative consequences associated with overusing releveraging. The combined loan payments can grow large relative to desired contributions, which locks in a future benefit level and limits the company's ability to recycle with contributions. The ESOP trustee also may not approve additional releveraging if the percentage of unallocated shares climbs above a reasonable level.

There are many factors to consider when determining which of the "Three R's" is the best fit; nuances within each method can greatly impact the results. It might be necessary to use a combination of methods and the best approach may evolve over time as the ESOP matures or business conditions change. Determining an optimal strategy requires a company-specific analysis, with careful consideration of the goals for the ESOP and the implications for all stakeholders. ■

About the Author

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