



The Mid-Atlantic Chapter of
The ESOP Association

Understanding Recycling & Redemption and if Releveraging might be right for your Plan

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- Mr. Williams is a Senior Plan Administrator for Blue Ridge ESOP Associates and has over 12 years of experience in employee benefits, with a focus on plan design, implementation, administration and consulting services for ESOPs. He is a member of The ESOP Association, the National Center for Employee Ownership and is a speaker at various ESOP conferences. Jon earned a Bachelor of Science in Business from Virginia Commonwealth University, where he majored in Accounting and minored in Economics.



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Agenda

- **Recycling vs. Redeeming**
 - Correlation to ESOP Repurchase Obligation
 - Impact on Valuation
 - Definitions
 - Pros and Cons
 - Target Benefit levels
 - Size of Repurchase obligation
- **Re-leveraging**
- **Conclusions**



Repurchase Obligation 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

The ESOP sponsor is responsible for monitoring the repurchase liability and keeping the ESOP sustainable

What Impacts Repurchase Obligation?

- ☐ Employee demographics, age profile
- ☐ Employee turnover rates and patterns
- ☐ Death, disability
- ☐ Changes in size of workforce
- ☐ Salary increases, compensation of new hires
- ☐ Stock acquisition loan term; debt prepayments
- ☐ Share value/appreciation (depreciation) in value
- ☐ **Distribution Policies and Practices**
- ☐ Election rates - Diversification
- ☐ Plan design



Repurchase Obligation Funding

- Pay as you go
- Pre-funding the ESOP
- Sinking funds
- Insurance
- Internal Markets
- Sale of the Company
- Company debt



What is the Benefit Level?

The ESOP benefit level is the value the participants receive from the ESOP on an annual basis

Elements that make up the ESOP benefit level:

- Value of shares released from loan payments

- Value of shares recycled

 - Employer Contributions

 - Dividends/S Distributions

 - Excluding shares recycled with existing ESOP cash

- Value of shares contributed through stock contributions

- Value of reallocated forfeitures

- Cash contributed, not used for debt or repurchase obligation

- Dividends/S distributions not used for debt or repurchase obligation

Dividends/S distributions optional

Benefit Level is often communicated as a percent of qualified payroll



Usual Factors That Lead to Unsustainable Benefit Level

- ☐ Improper internal loan terms
- ☐ Large demographic bubble, increased repurchase obligation
- ☐ Distribution policy
- ☐ Rate of share price appreciation

Value to Payroll Ratio

- Allocated share value divided by qualified payroll
- Quick and effective way to gauge the long-term sustainability of an ESOP
- The greater the ratio, the more difficult it is to manage to a controlled benefit level
- May impact ongoing repurchase methodology

	1:1	2:1	5:1	10:1
Allocated Stock Value	\$1,000,000	\$2,000,000	\$5,000,000	\$10,000,000
Qualified Payroll	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Estimated RO (5% of Allocated Shares)	\$50,000	\$100,000	\$250,000	\$500,000
Benefit Level (Recycle)	5%	10%	25%	50%
Max Contribution	\$250,000	\$250,000	\$250,000	\$250,000
Dividends/S Distributions Required	\$0	\$0	\$0	\$250,000



Benefit Level Impacts on Company

- **Low benefit levels can lead to:**
 - Issues motivating employees
 - Hiring/retention
 - Not benefiting from the “Employee Owned” culture

- **High benefit levels can lead to:**
 - Inconsistent benefit level
 - Increased repurchase obligation
 - Cash flow concerns
 - Compliance testing issues (Most notably 404a and 415)
 - Creating an unrealistic long term expectation for plan participants.

The 5 R's

- **Recycle** – Shares stay within the plan and are reallocated using cash from contributions
- **Redeem** – Shares are purchased from participants and retired or recontributed
- **Releverage** – Shares are repurchased and used to create a new ESOP loan
- **Rebalance** – Shares and cash are “rebalanced” so that participants hold equal proportions of each. E.g. 75% shares 25% cash
- **Reshuffle** (Segregation) – Shares are repurchased from terminated participants in the year of termination and recontributed, redeemed or releveraged



Share Repurchase Strategies - Recycling

- Company contributes cash to ESOP (or uses cash already in the ESOP if enough is available)
- Contributed cash allocated to current employees eligible to receive an allocation
- Terminated participant seeks a distribution
- ESOP exchanges cash in current employees' accounts for stock from terminated employees' accounts
- Stock purchased with cash allocated to current employees' accounts pro rata
- Effectively, substitutes a cash benefit for a stock benefit



Share Repurchase Strategies - Recycling

Example:

- 10 terminated participants own 20,000 shares of stock worth \$200,000.
- The company contributes \$200,000 in cash to the ESOP Trust to fund their distributions.
- The \$200,000 contribution is allocated to eligible ESOP participants at year-end based on the ESOP's allocation formula.
- The \$200,000 in cash is then used to pay terminees and their 20,000 shares of stock transfer/recycle back to those who gave up cash.



Share Repurchase Strategies - Recycling

- Recycling directly impacts your benefit level
- Can result in inconsistencies on an annual basis
- IRS statutory limits on cash contributed to the ESOP
- If other outside shareholders then won't have to worry about losing ownership %
- Number of shares outstanding and ESOP % remains constant
- Will have to repurchase the same shares again in the future –over and over again

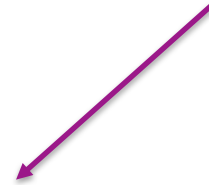
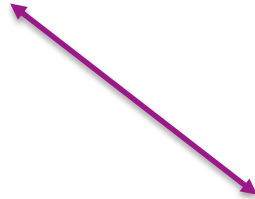


Redemption

Company

ESOP

Participant



Share Repurchase Strategies - Redeeming

- No new benefit to employees (unless you re-contribute back to the ESOP)
- No tax deduction
- Reduction in ESOP ownership
- Reduction in outstanding shares

Options:

- Redeem and retire shares
- Redeem and recontribute shares
- Redeem and re-leverage

Can redeem from the ESOP trust/active participants' accounts. This is not as part of the distribution process and not a topic of conversation today.

- ✓ Fiduciary issues
- ✓ Need an as of transaction date valuation



Redemption

- Will not have to repurchase these shares in the future
- Company can elect to re-contribute these shares or a portion of them to the plan
- May be a benefit to departing participants if NUA (net unrealized appreciation) exists
 - **Trustee should be concerned if other shareholders exist who are being counter diluted up**
 - **Reduces number of outstanding shares**



Redeem and Retire

➤ Redeem and retire shares

- Effectively manages benefit level to desired company contributions
 - No impact on earnings (funds taken from balance sheet)
-
- But, reduction in number of shares outstanding may result in value per share growing more rapidly than aggregate equity value
 - Provides a return to the shareholder
 - Can be an issue when communicating performance to participants
 - Tends to concentrate value
 - Accelerated RO
 - Have/Have-Not problem

Redeem and Recontribute

Redeem and recontribute shares

- Some or all redeemed shares may be recontributed
- Mitigates counter-dilutive impact of redemptions
 - Universe of outstanding shares not reduced as much
- Similar to recycling with contributions
 - Provides a benefit to participants (allocated pro rata to compensation)
 - 25% contribution limit applies to total contribution, including stock
- But, if all redeemed shares are recontributed, same challenges as recycling with contributions (e.g. variable benefit level)

Share Repurchase Example - Redeeming

- - 10 terminated participants who own 1,000 shares of stock worth \$50,000 request distributions
- - ESOP distributes 1,000 shares of stock
- - Company pays \$50,000 for the stock in response to the “put” option
- - Shares are retired to Treasury
 - Or reverted back to authorized and unissued shares if no Treasury stock in states like Virginia.
- - ESOP owns 1,000 fewer shares



Recycling vs. Redeeming: Recap

	Redeem	Recycle (Contributions)	Recycle (S-Distributions)
Shares Outstanding	Reduced	No Impact	No Impact
ESOP Ownership	Reduced if < 100%	No Impact	No Impact
Add'l Shares to Participant Accts.	No	Yes	Yes
Employee Group Who Benefits the Most	Longer-term EEs with larger share balances	All active participants who qualify for cont.	Longer-term EEs with larger share balances
Per Share Value	No Dilution	Dilution	Dilution
Corp. Cash Flow	Reduce	Reduce	Reduce
Income Tax	No Deduction	Deduction for Contribution	No Deduction



What is Releveraging

- Repurchased shares are redeemed then sold back to the ESOP for an internal loan
 - Fresh shares can also be added or sold stand alone
- The company sells newly issued shares to the ESOP to be held in suspense
- New ESOP loan created and shares are “released” and allocated as the loan is repaid

Can be used on a one-time or periodic basis to handle unusually high repurchase obligations

Re-Leveraging Example

- **Successful Engineering Company**
- **40% leveraged ESOP purchase**
- **8% target benefit level**
- **Historically Recycled Shares**
- **Older demographics**
- **Diversification Began to Apply**
- **Processed Lump Sum Distributions which churns shares quickly**



Re-Leveraging Example

- Shares recycled in the ESOP as stock price grew
- Increased Repurchase Obligation as account balances grew
- Benefit Levels were higher than targeted
- How would Re-Leveraging help in this situation?
 - Shares recycled would decrease
 - Near-Term Repurchase Obligation would decrease
 - Benefit Levels smoothed out
 - Shares available for new and future employees



Pros of Re-Leveraging

- Shares are allocated gradually, rather than all at once
 - Benefit Level
 - Repurchase Obligation
 - IRS Limits
- Ongoing contributions for loan payments are deductible
- ESOP Ownership and Outstanding Shares are unchanged
- Can help with “Have and Have-Not” culture issues



Cons of Re-Leveraging

- Post-transaction dilution of value (participants with the highest share count affected the most)
- Increased Fiduciary Risk related to the transaction between the company and the ESOP
 - Trustee may require an adequate consideration opinion
- Added transactional costs
- Tax Strategy may be inefficient in comparison to re-contributing shares-N/A 100% S ESOPs
- Some industry professionals feel a company should be sold before it re-leverages; seek the advice of ERISA counsel if considering selling fresh shares to your ESOP. Trustees and all parties to the transaction should follow the DOL Fiduciary Process Agreement for ESOP Transactions.

Comparison of Redeem vs. Recycle and Redeem vs. Releverage

	Redeem	Recycle	Releverage
Shares outstanding	Reduced	No impact	No impact (*)
ESOP ownership	Reduced if < 100%	No impact	No impact
Additional shares to Employee ESOP accounts	No	Yes	Yes, over time
Per share value	Anti-dilution	Diluted	Diluted
Employer contribution	No	Yes and dividends/ S distribution	Yes and dividends / S distribution
Employee group benefited most	EEs with larger share balances	Depends upon funding Contribution (EEs) Dividends (Participants)	Contribution (EEs)
Corporation's cash flow	Reduce	Not Reduced if = Benefit Expense	Not reduced if =Benefit Expense
Income Tax	No deduction	Deduction for employer contribution	Deduction for employer contribution



Questions?



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ADMIN

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