Repurchase Obligation and ESOP Valuation
Presented by
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Does Repurchase Liability Affect Value?
- Frequently discussed and debated topic
- Growing number of 100% and majority-owned ESOPs has increased the focus on repurchase liability
- Key questions:
  - Does the cash outflow required to fund repurchase liability affect the company’s ability to fund cap ex or future growth?
  - Does the level of retirement benefits the company is providing to its employees through the ESOP impact share price?
  - Does the method of repurchasing ESOP shares impact share price?
  - Does the method of saving for future repurchase liability impact a company’s valuation?

Potential Valuation Techniques to Address Repurchase Obligation
- There are several ways to address repurchase obligation within a valuation. However, this is still a gray area within the ESOP valuation community.
  - Start with a repurchase obligation study
  - Compare projected repurchases with “normal” retirement benefit levels
  - Understand the inter-relationship between ESOP repurchases, employee benefit levels, and the performance of the Company
- A specific valuation adjustment might not be necessary.
- However, simple modifications can be made to a valuation to incorporate the impact of future repurchase obligation, if necessary.
  - Multiple selection/discount rate
  - Estimate PV of future excess retirement benefits
  - Marketability/Equidity discount
  - Other
Private companies that sponsor ESOPs must provide a put option to ESOP participants.

The put option obligates the company to buy back shares from participants at fair market value.

This creates the repurchase obligation.

*IRC 409(h)(1)(B)* if the employer securities are not readily tradable on an established market, has a right to require that the employer repurchase employer securities under a fair valuation formula.

Two traditional methods to handle repurchase liability and satisfy the put option:

- **Redeem shares**
  - Participants receive a distribution of shares
  - The shares are sold back to the company and leave the ESOP
  - The company’s equity value declines, but no dilution to the remaining shareholders’ per share value.
  - The ESOP’s ownership percentage decreases (if less than 100% ESOP-owned).

- **Recycle shares**
  - The ESOP purchases shares from departing participants
  - Cash contributions, dividends/S distributions, or existing plan assets fund the purchases.
  - The shares are reallocated to the other ESOP participants
  - ESOP ownership percentage remains the same.
  - The company’s equity value declines and per share value is diluted.

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### Impact of Redeeming

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<td>Shares of Shares Outstanding</td>
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<td>Price per Share</td>
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### Impact of Recycling

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### Recent alternative method to handle repurchase liability and satisfy the put option

- **Releverage shares**
  - Participants receive a distribution of shares
  - The shares are sold back to the company
  - The company sells newly issued shares to the ESOP
  - ESOP loan created and ESOP shares are allocated as the loan is repaid
  - ESOP ownership percentage remains the same
  - The company’s equity value declines, and per share value is diluted (but most likely less dilution in per share value in comparison to the recycling scenario due to the ESOP debt tax benefit associated with releveraging)

- Typically requires an adequate consideration opinion since the ESOP is buying shares.

### Interactive Repurchase Liability Study

- Conduct an interactive repurchase study that involves your independent appraiser
- Include both the ESOP and executive compensation programs (both are often unfunded)
- Do iterative analyses that consider cash outflow for both obligations and resulting outstanding shares
- Allows the Company to analyze the relative relationships among the three “R”s (redeeming, recycling, and releveraging) over a 10-20 year period.
Interactive Repurchase Liability Study

Process
- Company: Prepare long-term baseline projections including earnings, cash and debt balances
- Appraiser: Estimate long-term per share ESOP values
- Consultant: Perform repurchase liability study and provide the following outputs for each scenario:
  - Repurchase liability (dollars)
  - Dividends/distributions (dollars)
  - Anticipated ESOP “contributions” (dollars)
  - Shares outstanding
- Appraiser: Modify long-term per share ESOP values based on changes to cash, debt, ESOP tax shield, and shares outstanding for each scenario
- Appraiser and consultant repeat above as necessary to collar results

Interactive Repurchase Liability Study

Interactive Repurchase Liability Study

Interactive Repurchase Liability Study
Interactive Repurchase Liability Study

Repurchase Method: Impact on Value Per Share

Monitor ESOP Cash Build-up

Repurchase Liability

- The appraiser should review current and projected repurchase liabilities
  - Do the obligations create significant cash flow strains?
  - Does the company have funding set aside to meet the obligations?
- Important to project future repurchase liability through a formal study or demographic data analysis
### Factors That Impact Amount of Repurchase Liability

- Redeem vs. recycle vs. releverage
  - Blending various repurchase methods may be the best technique in achieving appropriate targeted ESOP benefit levels
- Percentage of ESOP ownership
  - Increasing number of 100% ESOPs
  - Tax savings
- Historical and projected growth in value
- Demographics
  - Turnover trends
  - Typical employee age and length of service
- Is the plan leveraged?
  - Repayment period
  - Are distributions being delayed?

### Factors That Impact Amount of Repurchase Liability

- Plan distribution policies
  - Timing
  - Lump sum vs. installment payments
  - Consider cost of delaying payments which results in repurchase liability growing at the company’s cost of equity
- Plan contributions and dividends/S distributions
  - Funding available to recycle

### Questions

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Matt Keene is a Vice President of Consulting in Retirement and Investor Services for the Principal Financial Group. He works with clients on employee stock ownership plan ("ESOP") design and implementation in order to bring the full creativity afforded by ESOPs. Matt and his team draw on their hundreds of ESOP implementation experiences to tailor custom ESOP designs and perform full financial impact analyses for selling shareholders, ESOP-owned companies and employee-owners.

Matt received a Bachelors of Science degree in Business Administration and a Master of Accounting degree from the University of North Carolina at Chapel Hill. He is member of The ESOP Association and the Carolinas Chapter, where he serves as Vice President.

Andrew S. Ward

Mr. Ward is a Managing Director in the Valuation and Financial Opinions Group at Stout Risius Ross, Inc. His concentration is in ESOP and ERISA advisory services. Mr. Ward has 16 years of experience in providing valuation and financial advisory services for privately held and employee-owned companies. In particular, he has advised numerous clients in structuring and negotiating ESOP transactions, including leveraged ESOP buyouts.

Mr. Ward is a member of the ESOP Association and its Valuation Advisory Committee and Board of Governors, the National Center for Employee Ownership, and the Business Valuation Association of Chicago. He also frequently speaks at professional conferences and seminars and authors articles on valuation and ESOP related topics.