Sample Company

<u>ESOP Repurchase Obligation Study</u>

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What is the Repurchase Liability?

- A claim on the future cash flow of the Company that sponsors the ESOP
- A general obligation of the plan sponsor

What is the Repurchase Liability?

- Participants hold a “put option” requiring the corporation to buy back their vested stock account balances at fair market value; IRC 409(h)
- Off balance sheet liability

Five Events That Trigger a Distribution

1. Retirement
2. Death
3. Disability
4. Diversification (25% at age 55 <u>and</u> after 10 years of participation; after six more years up to 50%)
5. Termination (voluntary or involuntary)

What to Do With the Repurchased Shares?

- Redeem
- Recycle

What to Do With the Repurchased Shares? - Redeem

- Company purchases stock from ESOP participants or those entitled to a distribution
- Shares held as treasury stock for future use
- Reduces the shares in the ESOP
- Non-ESOP stockholders increase their ownership % as stock is redeemed

What to Do With the Repurchased Shares? - Recycle

- ESOP or the Company purchases stock from participants or those entitled to a distribution
- Shares stay in the ESOP and are reallocated to remaining ESOP participants
- Can be used to keep the ESOP percentage ownership constant

Repurchase Obligation Management - What's the Goal?

- Strike a balance between current funding of repurchase obligation vs. company growth
- Mitigate and manage risks to future cash flow
- Make good on compensation promises
- Sustain stable ongoing business (free from unexpected cash calls)

Starting Point – Common Assumptions

- Repurchase obligation is a legal off balance sheet liability – IRC§409(h)(1)(b)d
- The cost to redeem or recycle is a call on future cash flows
- One of the primary metrics in determining FMV is by using discounted cash flow models
- Funding effects cash flow; The decision not to fund effects value

Starting Point – Common Threats

- Difficulty securing bank loans, trade credit and/or bonding
- Erosion of employee morale
- Personal liability for fiduciaries
- Constricted cash flow to fund current & future opportunities
- Employees remaining with Company face a compression in retirement value due to overstatement of cash flow in early years
- Unexpected terminations, disability or death

Step 1 – Perform Repurchase Obligation Study

- Forecast liability
- Run multiple scenarios to determine range of outcomes
- Calculate cost on NPV basis

Step 2 – Evaluate Results

- Review forecasts vs. long term strategic plans & financial projections
  - Will the ESOP buy additional shares from outside shareholders? If so, what will it cost?
  - Is there existing transaction debt that may impact your Company's cash flow and therefore its ability to fund the repurchase obligation?
  - Will your Company need cash to make future acquisitions or to facilitate a merger?

Step 2 – Evaluate Results, cont'd.

- Review forecasts vs. long term strategic plans & financial projections
  - Does your Company expect future divestitures that may require cash to meet participant payouts?
  - Does your Company wish to perpetuate employee ownership or conversely plan on shrinking the ESOP?

Step 2 – Evaluate Results, cont'd.

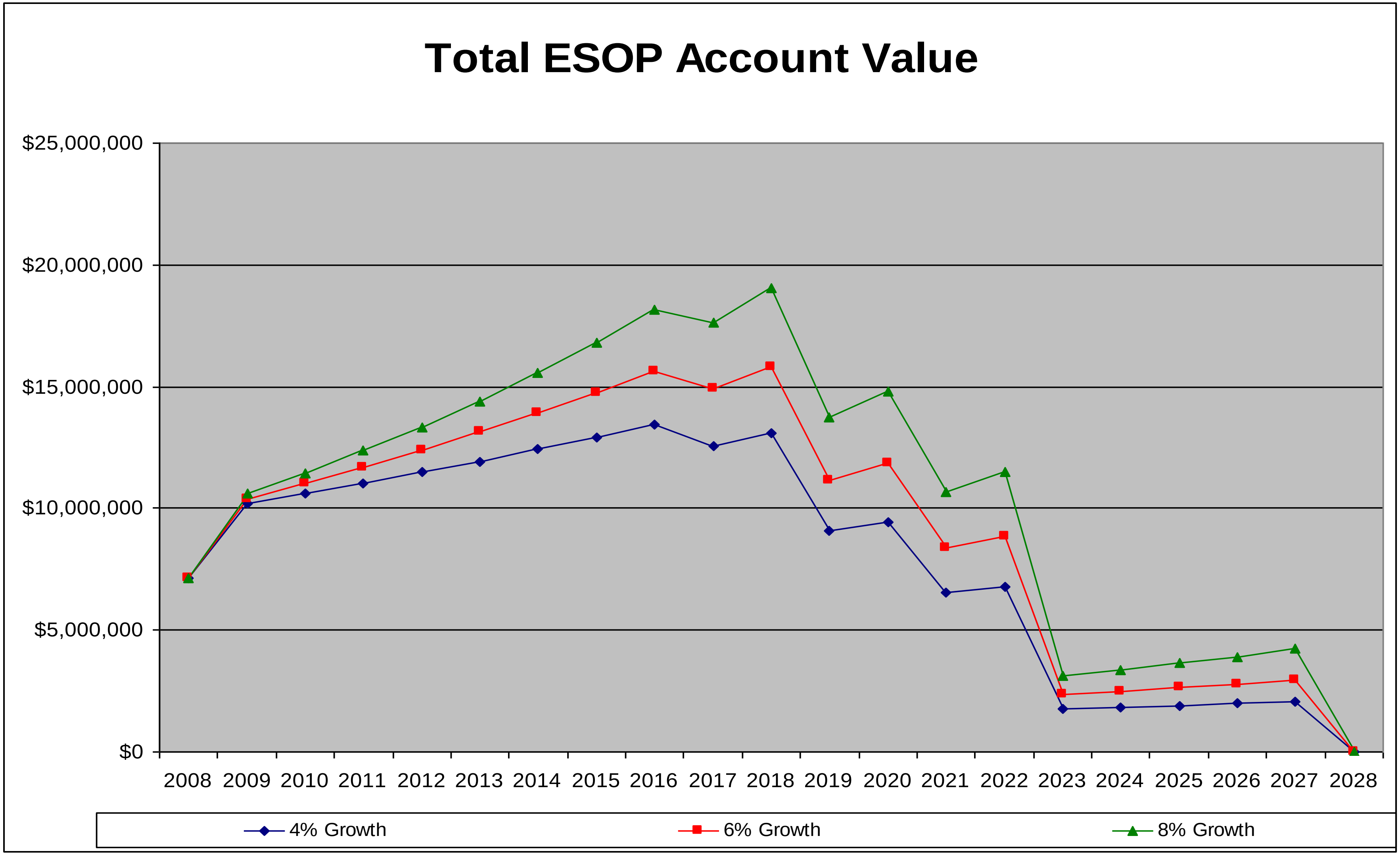
- Understand factors influencing magnitude & timing of liability
  - Demographics
  - Distribution policy
  - Outstanding ESOP debt
  - Cash flow & stock value

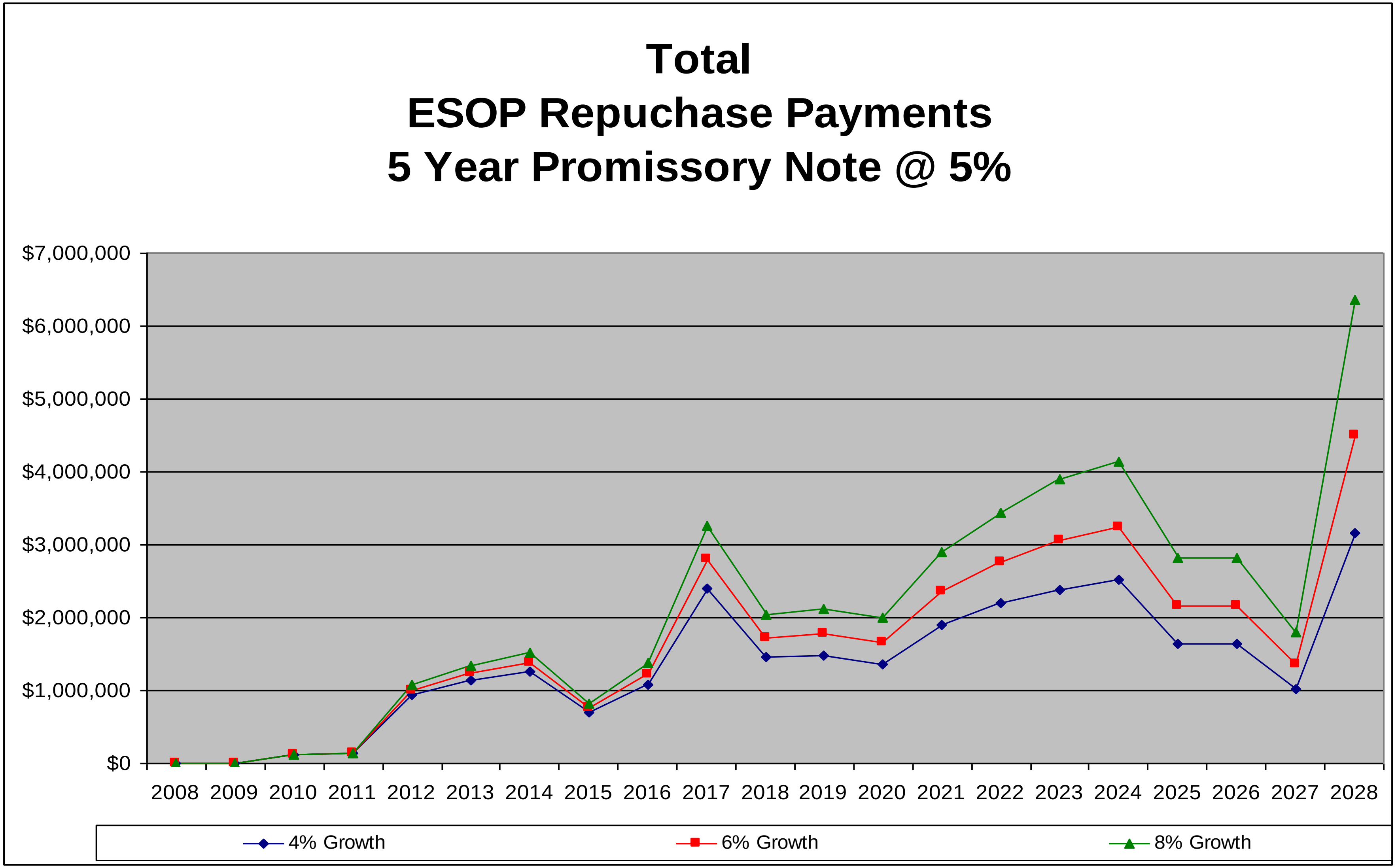
Step 3 – Evaluate Funding Strategies

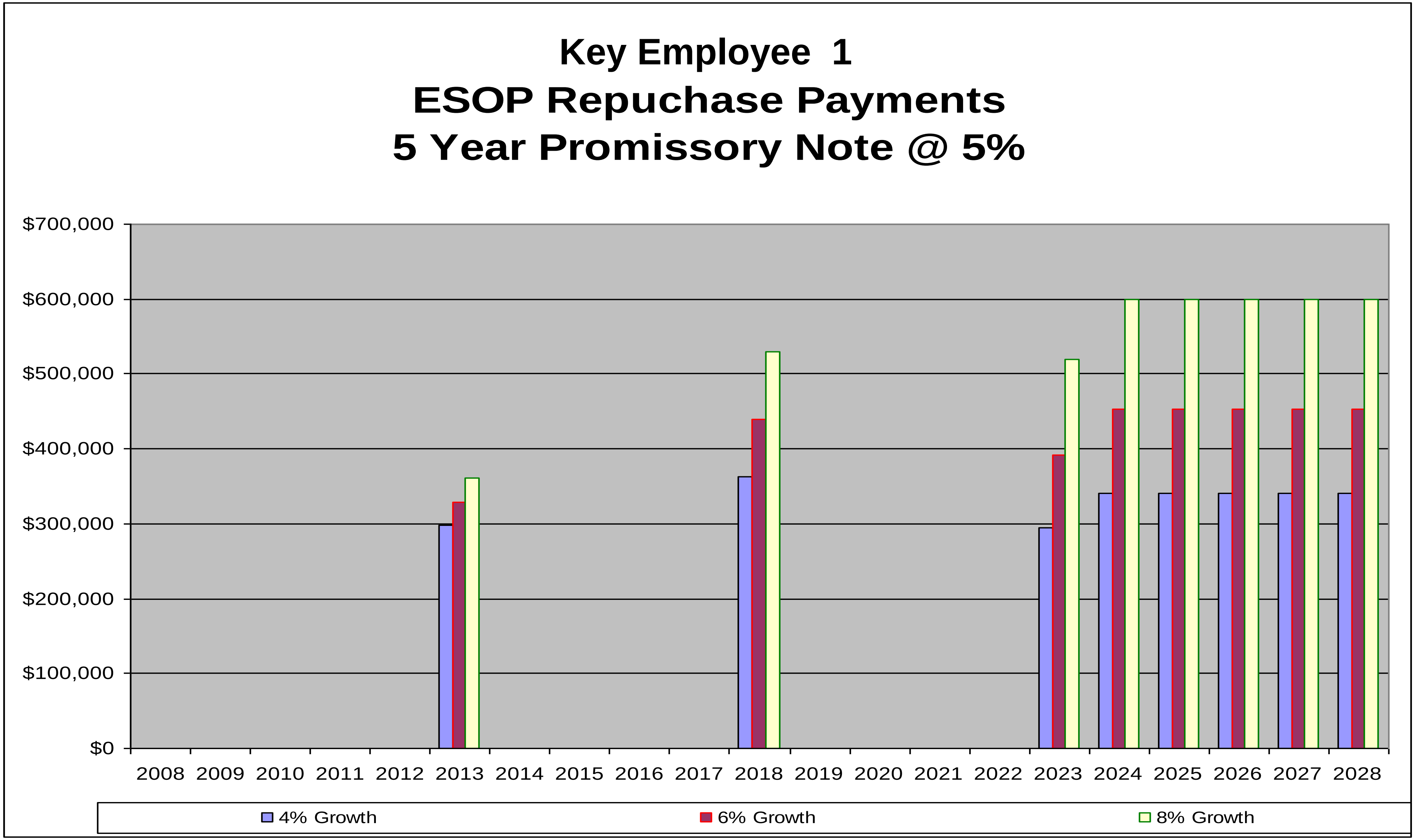
- Determine asset/liability gap
- Determine amount of excess cash that can be devoted to funding liability
- Evaluate funding alternatives and determine desired amount to fund from cash flow vs. sinking fund vs. sale of assets
- Determine the desired mix of taxable vs. tax-advantaged investments
- Document the funding policy

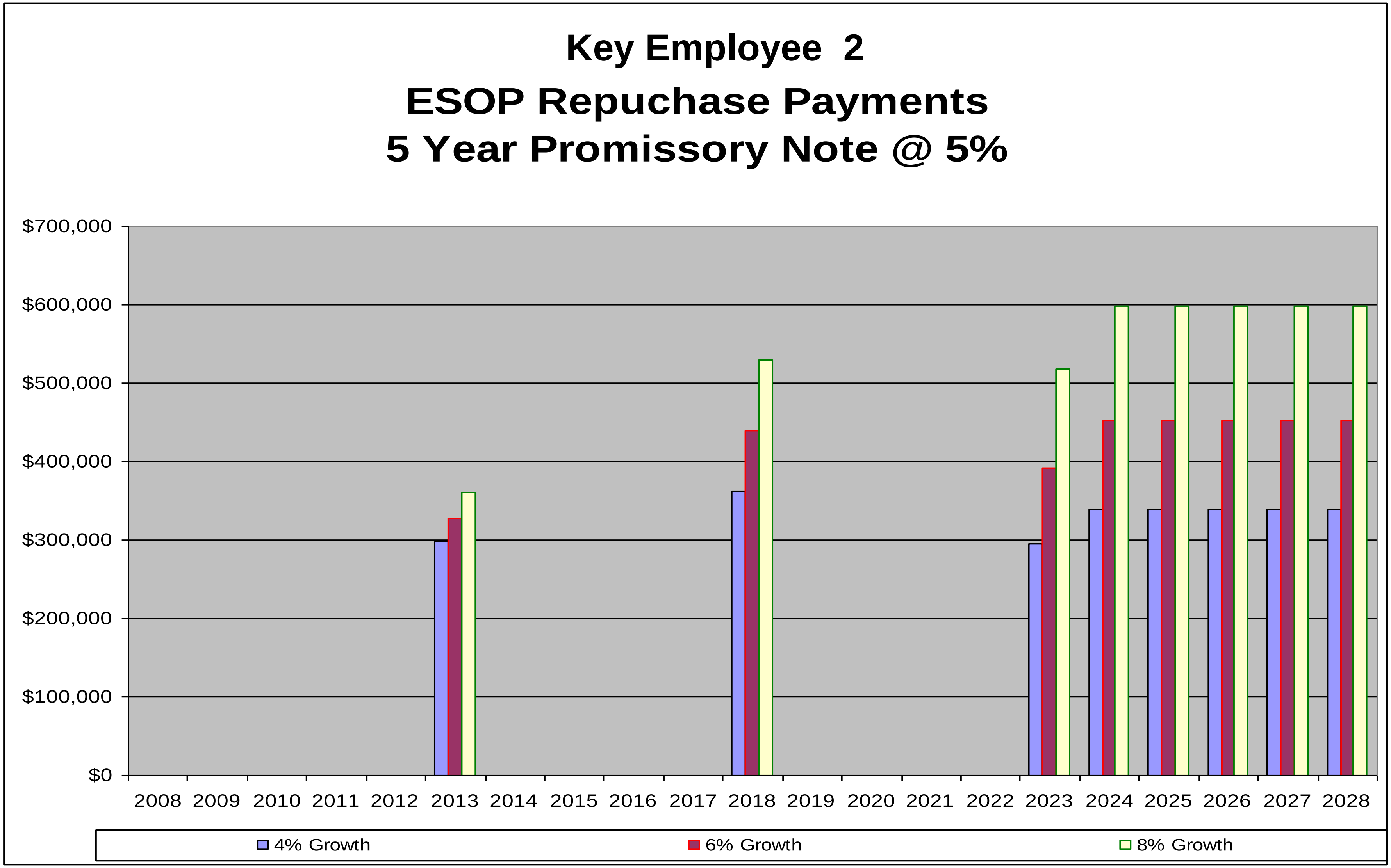
Step 4 – Implement Funding Solution(s)

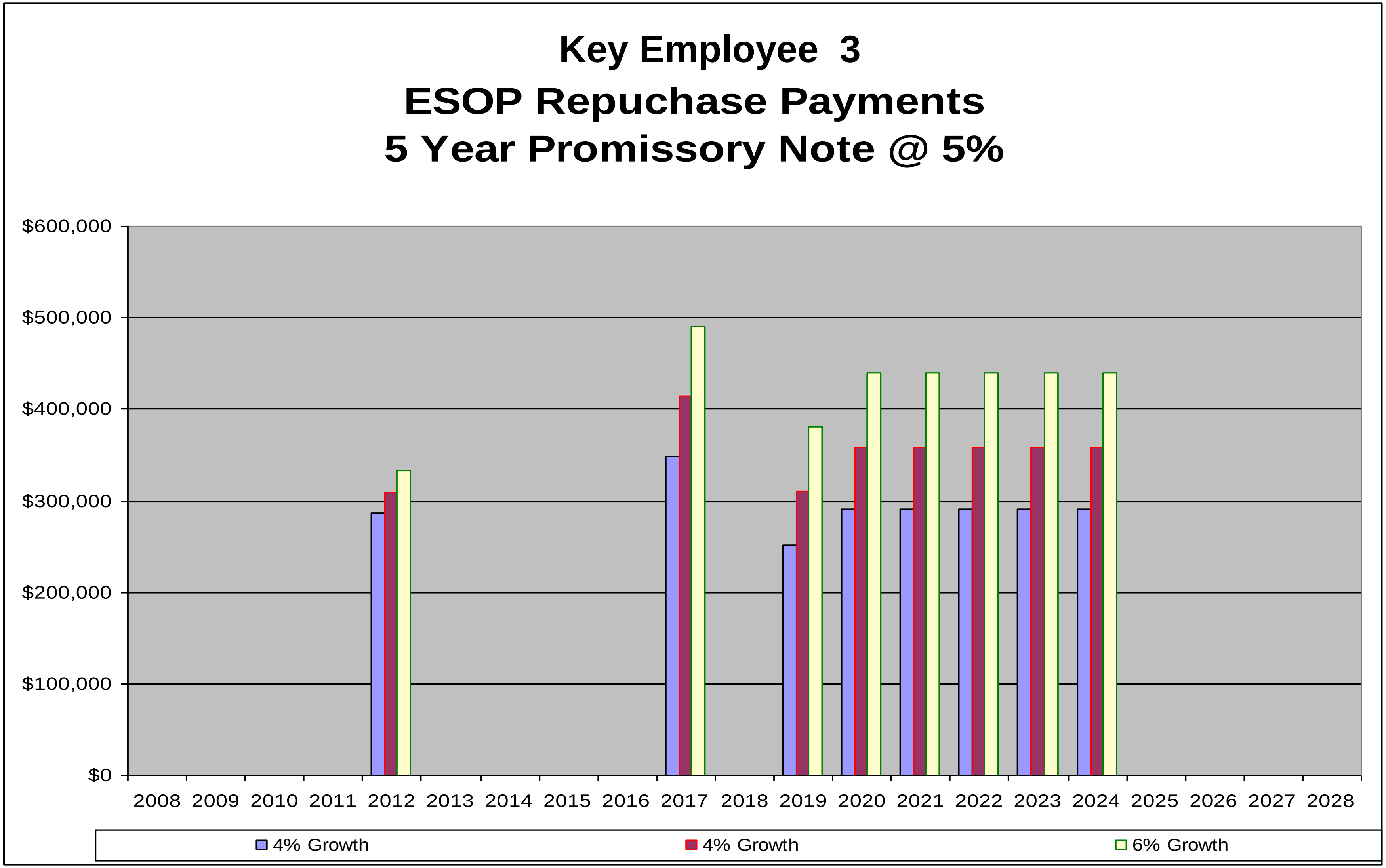
- Ascertain acceptable risk levels
  - Back-testing worst case and maximum draw down
- Determine cash budget for funding
- Determine optimal asset allocation
- Estimate probabilities of success – Monte Carlo simulations
- Consider funding immediate liabilities from cash flow & long-term liabilities from investments

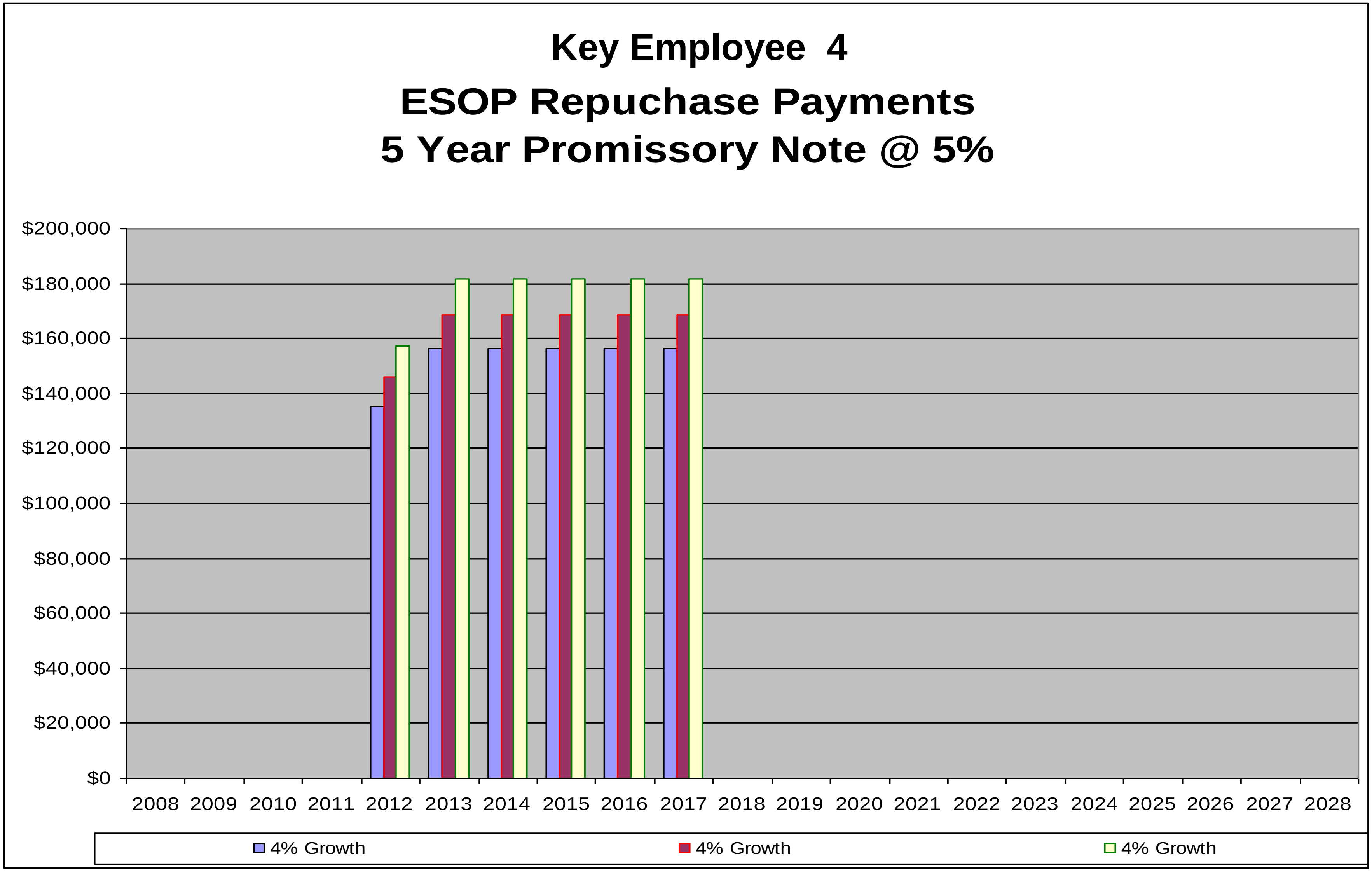

Total ESOP Account Value
$25,000,000
$20,000,000
$15,000,000
$10,000,000
$5,000,000
$0
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028
4% Growth
6% Growth
8% Growth

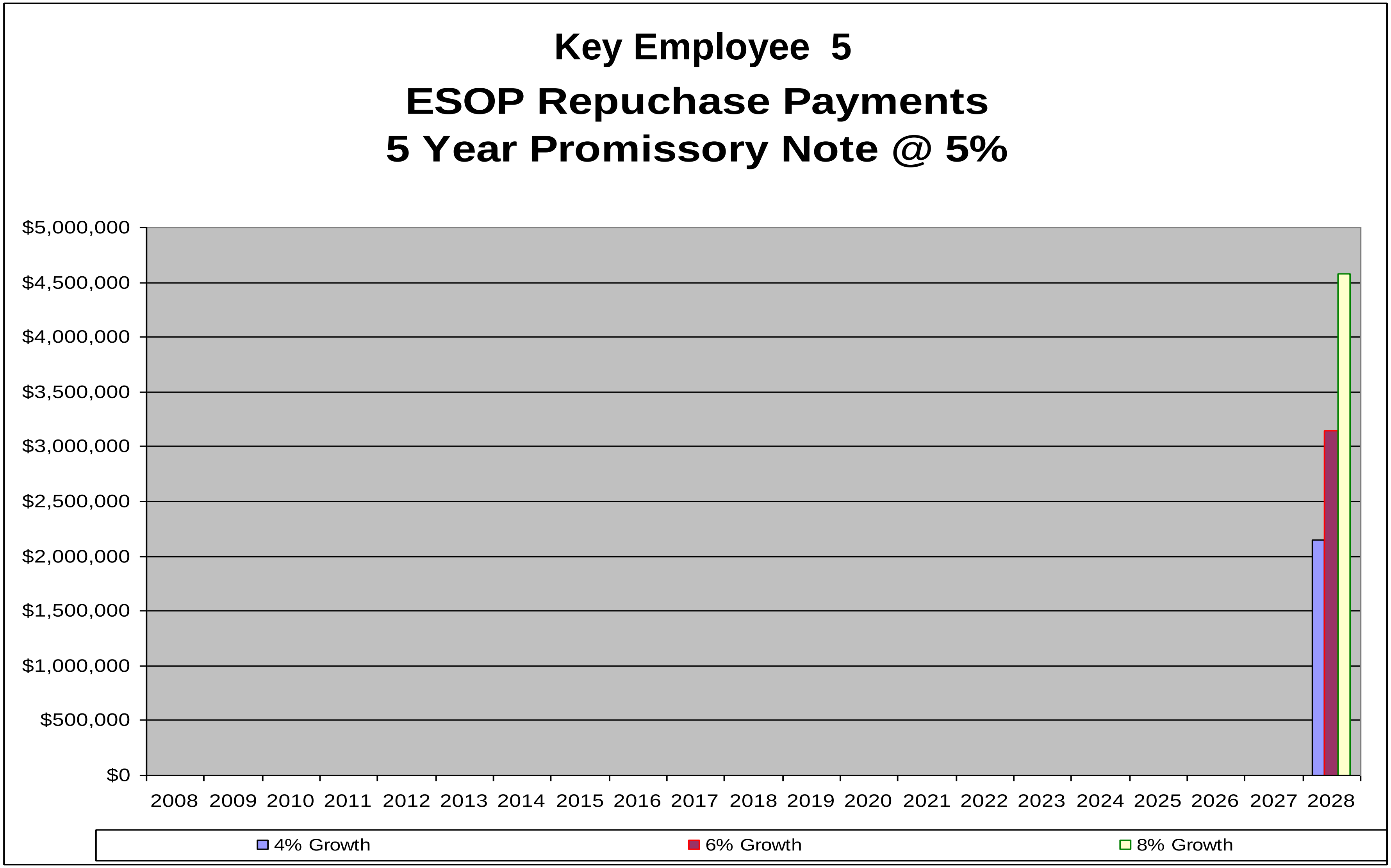

Total
ESOP Repuchase Payments
5 Year Promissory Note @ 5%
$7,000,000
$6,000,000
$5,000,000
$4,000,000
$3,000,000
$2,000,000
$1,000,000
$0
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028
4% Growth
6% Growth
8% Growth


Key Employee 1
ESOP Repuchase Payments
5 Year Promissory Note @ 5%
$700,000
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$0
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028
4% Growth
6% Growth
8% Growth

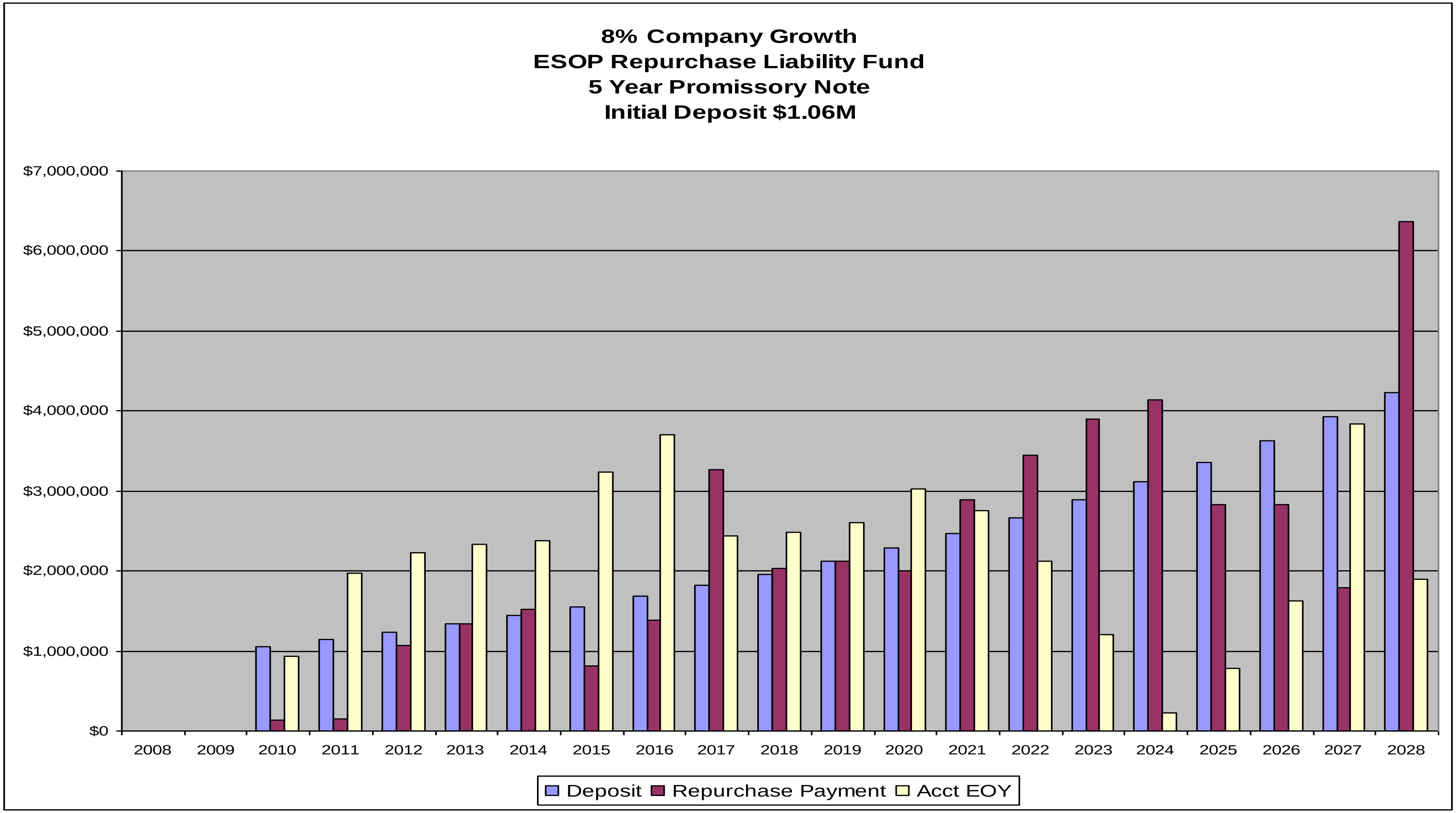

Key Employee 2
ESOP Repuchase Payments
5 Year Promissory Note @ 5%
$700,000
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$0
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028
4% Growth
6% Growth
8% Growth


Key Employee 3
ESOP Repuchase Payments
5 Year Promissory Note @ 5%
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$0
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028
4% Growth
4% Growth
6% Growth


Key Employee 4
ESOP Repuchase Payments
5 Year Promissory Note @ 5%
$200,000
$180,000
$160,000
$140,000
$120,000
$100,000
$80,000
$60,000
$40,000
$20,000
$0
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028
4% Growth
4% Growth
4% Growth

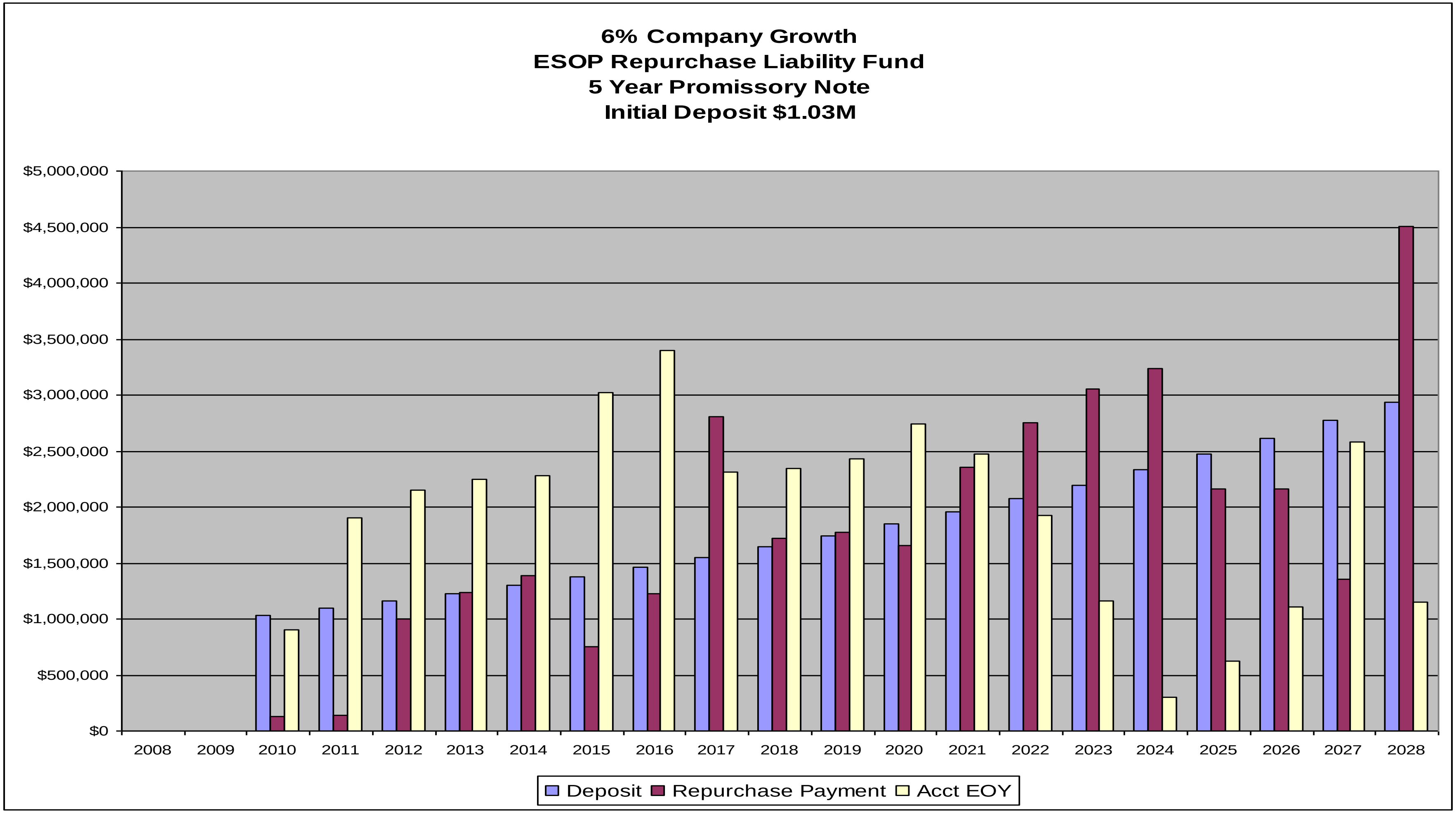

Key Employee 5
ESOP Repuchase Payments
5 Year Promissory Note @ 5%
$5,000,000
$4,500,000
$4,000,000
$3,500,000
$3,000,000
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$0
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028
4% Growth
6% Growth
8% Growth

Sample Company
ESOP Repurchase Obligation Study



Assumptions:
- Account Deposits will be made at the end of each year
- Interest earned on Deposits will be 5%
- Initial Deposit will be $1.06M and will compound annually at 8%

Sample Company
ESOP Repurchase Obligation Study



Assumptions:

- Account Deposits will be made at the end of each year
- Interest earned on Deposits will be 5%
- Initial Deposit will be $1.03M and will compound annually at 6%

Sample Company
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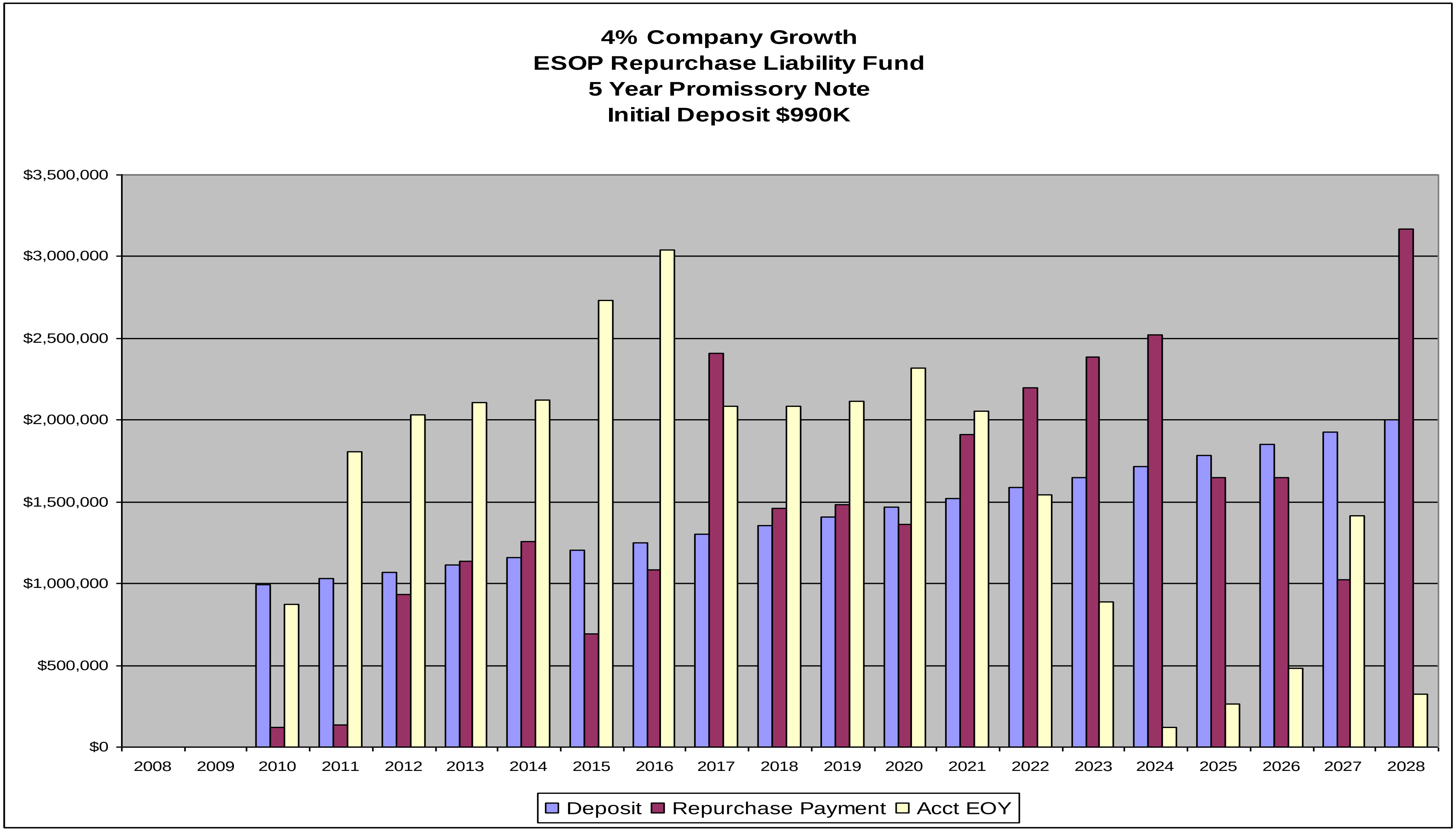

Assumptions:
- Account Deposits will be made at the end of each year
- Interest earned on Deposits will be 5%
- Initial Deposit will be $990K and will compound annually at 4%

Repurchase Liability Projection
Assuming 6% Company CAGR

• Total Repurchase Liability	$35,420,926
• Years 1 – 10	$10,398,454 (30%)
• Years 11 – 20	$25,022,247 (70%)
• NPV of the RL Over 20 Years (Assuming 5% discount rate)	$18,924,952