ESOP ECONOMICS

REPURCHASE OBLIGATION EXPERTS

DOING AN ESOP REPURCHASE OBLIGATION STUDY

CFOs at ESOP companies acknowledge the importance of planning for the cash requirements associated with ESOP distributions. However, the prospect of “doing a repurchase obligation study” can be daunting for many reasons; several underlying assumptions must be developed, the calculations are complicated, and making sense of the results can be challenging. Given the effort involved in doing a study, it must provide actionable information, and the answers to the company’s specific questions, to be worthwhile. Whether a company performs the study in-house or engages an outside professional, the process of performing a study should include the following steps.

DEFINING THE ISSUES

Every study should include a long-term projection of ESOP distributions and the associated company cash requirements.

However, management may have additional specific purposes for the study, for example, to quantify an anticipated “retirement bubble”, to forecast the benefit level provided to ESOP participants versus an established target benefit level, or to determine whether the ESOP is sustainable based on current practices.

Or perhaps changes are being considered. For instance, the company may be considering redeeming shares instead of recycling them, or changing its distribution policy or funding strategy. It is prudent to use a study to understand the implications of any proposed changes before implementing them.
The specific questions to be addressed in the study should be documented from the outset.

GATHERING DATA

The following data are necessary for the forecast:
- Census and account balances
- Loan amortization schedules
- Company financial projections
- Plan document, especially provisions related to eligibility, vesting, allocation method, retirement and diversification requirements, and distribution policy

DEVELOPING ASSUMPTIONS

Usually the most difficult and time-consuming part of doing a study is developing the relevant assumptions. And rightfully so, because it is well known that “garbage in = garbage out”. Projections are only as good as the underlying assumptions. Ideally, Finance and HR teams should collaborate to develop assumptions for a “base case” forecast that are reasonable and consistent with other company financial projections.

Key assumptions include the following:
- Turnover rates and patterns
- Hiring and salary increases
- Diversification election rates
- Repurchase method (recycling or redeeming shares) and funding strategy (contributions and S distributions / dividends.)

- Any future transactions
- Share value trajectory

Note: If share value is forecasted using a Discounted Cash Flow model, projected repurchase obligations should be integrated into the model. Developing the share value assumptions is, in this case, an iterative process.

MODELING A "BASE CASE" FORECAST

After the assumptions have been approved by key members of management, it's time to crunch the numbers. Using repurchase obligation software, or another model, a base case forecast can be prepared which incorporates current census data, plan provisions and practices, and best-guess assumptions.

ANALYZING RESULTS

One should keep an open mind when analyzing the results – sometimes the findings aren't as expected. What challenges is the company facing?

- Variable cash requirements / benefits
- Benefit levels that are too high
- Have and have not issues
- Declining number of shares
- Approaching IRC 404 limit for contributions (25% of covered compensation)
- Current funding strategy not working

Of course, the original questions to be addressed by the study should be answered.

MODELING ADDITIONAL SCENARIOS

If the base case results revealed no specific challenges, it may be useful to stress test key assumptions. How robust is the current strategy in an economic downturn?

If challenges were evident in the base case results, alternative strategies should be identified and modeled in order to address these challenges. Alternatives may include:

- Changes in distribution policy
- Changes in contribution, S distribution, or dividend level
- Redeeming vs. recycling shares
- Releveraging

Sometimes a combination of strategies is necessary to meet challenges while accomplishing corporate goals such as target benefit levels and ESOP sustainability.

DEVELOPING CONCLUSIONS AND PRESENTING RESULTS

After all scenarios have been modeled, the results can be analyzed and compared, and recommendations can be developed. How well do the alternatives solve challenges and meet objectives?

The findings of the study should be summarized in a report for the board of directors. The report should be easily digestible (bullet points and graphs) and provide actionable information.

A repurchase obligation study, when done right, is well worth the effort. A study should provide visibility on future company cash requirements, and empower management to make informed decisions on the best way to handle repurchase obligations given its goals for the ESOP.

ESOP ECONOMICS
REPURCHASE OBLIGATION EXPERTS

215.606.3600
www.esopeconomics.com