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Regional Breakout Session

Considerations for ESOPs

WHAT FLIES AND WHAT DOES NOT IN TODAY'S CLIMATE

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RELEVANT BIO

CPA 17 years, 15 in public accounting

Construction companies and developers throughout that time, and before

Leader in ARB's Employee Benefits Practice Group

Specialize in ESOPs and ESOP-owned companies

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TODAY

OVERVIEW

TYPICAL CONSIDERATIONS
- ESOP FORMATION GENERALLY
- ESOP FORMATION APPLIED TO SPECIFIC COMPANIES
- COMMITMENTS
- SURETY CONSIDERATIONS

RIGHT ABOUT NOW
- RECENT
- CURRENT
- FUTURE

QUESTIONS

OVERVIEW

Why do it?

Exit / liquidity for owner

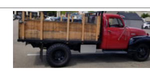
Tax

- Current owner – sale where buyer is not concerned about tax
- C-Corp gains often deferred by seller in 1042 transaction
- S-Corps – ESOP Trust gets K-1, pays no tax
- Employees – tax deferred compensation

Sincere desire for employee ownership, building on existing positive culture

ESOPs Up to Now

1950s: ESOPs created, with some tax advantages but little definition



1970s: Employee Retirement Income Security Act (ERISA) and ESOP became the qualified retirement plan concept it is today

2000s: 409(p) rules in place to limit S-Corp tax abuses.

2008: Great recession

Currently: COVID

ESOPs Today

~ $1.5 Trillion in plan assets nationwide

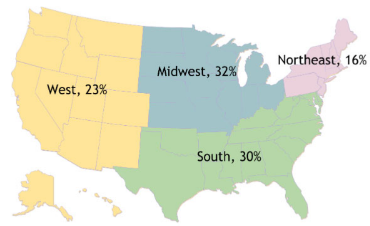
~15 million participants (~11 million active)

~6,500 companies sponsor ESOPs

>90% are closely held, nonpublic companies

10-15% are construction companies (increasing)

~8% of all corporate equity is controlled by employees



Source: NCEO

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Quick Overview – Financial Statements

LIABILITIES AND OWNER'S (DEFICIT) EQUITY

	AFTER	BEFORE
Total current liabilities	1,000,000	1,000,000
LONG-TERM LIABILITIES, net of current portions:		
Long-term debt	1,000,000	1,000,000
Note payable to director	7,000,000	-
Total long-term liabilities	8,000,000	1,000,000
OWNER'S (DEFICIT) EQUITY:		
Common stock, no par value, 200,000 shares authorized; 100,000 shares issued and outstanding	10,000	10,000
Unearned ESOP shares	(10,000)	-
(Accumulated deficit) retained earnings	(5,000,000)	1,990,000
Total owner's (deficit) equity	(5,000,000)	2,000,000
	$ 4,000,000	4,000,000

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CASH VS. NONCASH

Contributions
- P&L: If Company does well, high valuation, large compensation expense
- Cash: outlay is unaffected – expense is offset by a credit to equity

Repayment obligations
- Balance sheet/P&L: Not an expense or liability (equity transaction)
- Cash: buying back that equity will cost $$$$

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Quick Overview – Financial Statements

Pages of disclosure to

Describe key financial commitments of the Company regarding the ESOP
Describe circumstances where Company would not have to pay the former owner

Stock-based compensation (non-ESOP) often part of ESOP implementation

Should be disclosed
Even if no disclosure, ask
Sometimes there is a significant future, potentially hidden, cash outlay
Pegged to stock price, dilutes ESOP share value

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CONSIDERATIONS

Implementation - worth it?

Cost:
- $80K-300K formation in recent years
- $20K-70K annual compliance

Time, effort, responsibility
- Long process to implement
- Complex rules
- Fiduciary responsibility: need to be working in the best interest of the ESOP
- Figure it out now, hard to change provisions after its in place
- Unwinding ESOP is not fun

Uncertainty
- Volatility while a price needs to be determined (Covid?)
- Current priorities (Covid?)
- Is former owner still in management
- Loss of non-operational control, options removed

Implementation - compare:

Outside sale:

Various agreements / provisions

Legal, valuation and accounting fees

Possibly a commissioned broker / success fees

Inside sale:

Agreement can also involve tax inefficient bonuses to pay insider's financing

Regardless:

ESOP implementation is - and should be looked at as - a sale of the Company

- IRS/DOL writes many of the terms

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CONSIDERATIONS: BACK TO BASICS

Responsibility:

- Who is the trustee?
  - Outside or inside?
- Board of Directors, Administrative Committee, Officers, perhaps others – fiduciaries
  - ESOP participants must come first
- Current leadership structure:
  - Strong management?
  - Continuity plan?
  - Someone at the Company knows/learns a lot about ESOPs/stock-based comp

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BACK TO BASICS

History
- Has the Company been around a while?
- Does it have a strong financial position and track record of strong earnings?

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BACK TO BASICS – ALWAYS FLIES

An existing employee-focused culture and sense of ownership

The Company is strong and steady with long track record to prove it

A lot of employees, with a good range of ages (controls the flow of repayment)

Feasibility study performed, current owner is interested in the process, and outcome for the employee owners

Separate council for the proposed ESOP

Outside trustee

Current owners consult with you first

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BACK TO BASICS – MAY NOT FLY

Lone gun, one personality represents the Company's value, values and energy

Free cash flow low or uncertain

Trying to save bucks establishing plan / only one professional provides all advice / cutting corners at the outset

"I'm just a (fill in subcontractor specialty), I don't know anything about ESOP rules, (fill in advisor) takes care of all that"

Smaller companies (under 20) – numbers may not work

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BACK TO BASICS – MAY NOT FLY

Partial ESOP ownership without a game plan

No endgame in mind (form it and forget it, until you can't)

Highly cyclical (construction?)

Failure of poor planning: best case, ESOPs are frozen and eventually the now fully vested participants are paid out by the new (likely same as the old) ownership

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Good / Not so good

Good	Not so good
70 year old company	10 year old company
Top line and (generally) earnings growth each year for many years	ESOP was perhaps a way to turn company's potential and early goodwill (as seen in stock valuation) liquid
90 employees	20 employees
Slow process, over a year	A few months
Advisors from varied perspectives – not a "package" deal	Really one advisor – others were part of the "package"
Management team	Lone gun
Attentive management had already developed strong ownership culture	Lone gun again
Communications (Informative AND rah-rah)	Not much advertisement to employees
Maintenance costs low relative to Company size	Maintenance costs high relative to Company size

BACK TO BASICS: FUNDING

ESOP transaction debt

Contributions

Diversification

Repurchasing obligations

BACK TO BASICS: FUNDING

ESOP transaction debt

- Repayment of bank or shareholder financed note for stock sale to Company or ESOP
- Company note to ESOP is a wash

Repurchasing obligations & diversification requirements

- Appraised value represents current total eventual cash requirements
- High value company w/out liquidity… how does this get paid this year?
- Studies will be needed

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BACK TO BASICS: OTHER COSTS

SARs and/or other deferred comp arrangements

For top management, these arrangements can represent 50% <u>or more</u> of the claims to the Company's value increase… for 100% owned ESOP…

Should be considered in purchase price valuation

Should be considered in valuations going forward

Fiduciary and compliance responsibilities, administrative burden

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CONSIDERATIONS FOR SURETIES

For good candidates, when set up right:
- Mission, culture, direction
- Crucial continuity plan is in place

Shareholder distributions often not an issue

No S-Corp federal tax

Studies indicate ESOP-owned companies may be more profitable

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CONSIDERATIONS FOR SURITIES

More attractive:

- Long ESOP share release schedule
- Seller indemnification
- Repayment of stock sold to ESOP can be subordinated to surety, requiring meeting of metrics
- If properly negotiated, negative equity does NOT need to be viewed negatively in a seller finance… can add the note to the former owners back in
- Seller note can be reviewed and negotiated for modification

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RECENT, CURRENT, COMING UP

LATELY (NON-COVID)

Valuations
- Always #1. Not an issue until it is

Success fees are increasing
- Not really a brokered transaction

ESOP option utilized
- ESOPs gaining increasing acceptance and understanding
- Guaranteed sell – is the price right?
- Construction companies leading the way

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This year so far

2019 valuations completed

Interim valuations contemplated

Repurchase / diversification (cash flow) concerns, and

Extended 5500 deadline remains 10/15 - some are running late with this and other deadlines
- Compliance focus when in survival mode?
- Reprieve or understanding forthcoming?

Many anticipated ESOP formations have slowed down/paused
- Some still happen
- Similar to third party sales in this time

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HOW ARE ESOPS (ALL INDUSTRIES) ADDRESSING UNCERTAINTY WITH COVID

*NCEO survey May/June	Rev <$50MM (94 responses)	Rev >$50MM (66 responses)
Using emergency cash reserves	52%	56%
Freezes on pay increases across the board	41%	38%
Short-term financing other than a PPP loan	32%	30%
Reducing executive based pay	24%	35%
Layoffs	24%	36%
Furloughs	14%	29%
Reducing executive deferred pay	15%	17%
Saving cash by reducing contributions to benefit plans	13%	15%
Modifying bonus targets to make them easier to achieve	7%	15%
-Switching from cash to ER stock for retirement plan contributions	7%	11%
-Performing an interim ESOP valuation	10%	6%

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HOW ARE ESOPS (ALL INDUSTRIES) PERFORMING (TOP LINE) DURING COVID

Expectation of revenue 2020 compared to 2019*	
Flat or up	40%
Down up to 10%	30%
Down 10-25%	23%
Down 25 to 50%	7%
Down >50%	1%

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HOW ARE ESOPS (ALL INDUSTRIES) "FEELING" DURING COVID

How has being employee-owned affected your company's ability to respond to the coronavirus crisis, if at all?*	
Very positive effect	30%
Somewhat positive effect	36%
Neutral or no effect	32%
Somewhat negative effect	3%
Very negative effect	0%

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WHAT'S AHEAD?

October is employee ownership month

Election vs. Non-partisan issue
- AOC and a republican both proposed separate legislation centered around employee ownership

Partial plan terminations

Litigation

TODAY'S WORD IS:

VALUATION

VALUATION

What assumptions of growth are the purchase valuation based on?

- Top line and cash flow
- Past performance is no guarantee of future performance… But don't ignore it!

Most scrutiny (lawsuits) = price paid by ESOP for the Company

Right now: HIGH?

- What you don't see for new ESOPs are valuations based on projected losses
- Should be separate ESOP council (NOT company council) reviewing the initial valuation

Annual valuations

- Determines value of shares in participant accounts
- Which determines company cash flow

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Economy ~~is~~ was **booming** – What now?

New ESOPs: purchasing stock in recent economy… buying high?

Even in September 2020?

Have we seen the worst?

To assess true risks and issues, contemplate a downturn.

So who is taking the risk?

ESOP participants? Former shareholder(s)? Banks? Sureties?

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THANK YOU