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
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

Quick Overview – Financial Statements

<table>
<thead>
<tr>
<th>LIABILITIES AND OWNER’S (DEFICIT) EQUITY</th>
<th>AFTER</th>
<th>BEFORE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total current liabilities</td>
<td>1,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>LONG-TERM LIABILITIES, net of current payables to directors</td>
<td>1,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Total long-term liabilities</td>
<td>7,000,000</td>
<td>8,000,000</td>
</tr>
<tr>
<td>OWNER’S (DEFICIT) EQUITY:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock, at par value, 200,000 shares authorized, 100,000 shares issued and outstanding</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Total owners’ (deficit) equity</td>
<td>(5,000,000)</td>
<td>(6,000,000)</td>
</tr>
</tbody>
</table>
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 $$

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
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 it’s 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

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
BACK TO BASICS

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

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
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

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
### Good / Not so good

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

### 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

BACK TO BASICS: OTHER COSTS

SARs and/or other deferred comp arrangements
For top management, these arrangements can represent 50% or more 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
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

CONSIDERATIONS FOR SURETIES

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
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
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

HOW ARE ESOPS (ALL INDUSTRIES) ADDRESSING UNCERTAINTY WITH COVID

*NCEO survey May/June

<table>
<thead>
<tr>
<th>Action</th>
<th>Rev &lt;$50MM (%)</th>
<th>Rev &gt;$50MM (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Using emergency cash reserves</td>
<td>52%</td>
<td>56%</td>
</tr>
<tr>
<td>Freezes on pay increases across the board</td>
<td>41%</td>
<td>38%</td>
</tr>
<tr>
<td>Short-term financing other than a PPP loan</td>
<td>32%</td>
<td>30%</td>
</tr>
<tr>
<td>Reducing executive based pay</td>
<td>24%</td>
<td>35%</td>
</tr>
<tr>
<td>Layoffs</td>
<td>24%</td>
<td>36%</td>
</tr>
<tr>
<td>Furloughs</td>
<td>14%</td>
<td>29%</td>
</tr>
<tr>
<td>Reducing executive deferred pay</td>
<td>15%</td>
<td>17%</td>
</tr>
<tr>
<td>Saving cash by reducing contributions to benefit plans</td>
<td>33%</td>
<td>15%</td>
</tr>
<tr>
<td>Modifying bonus targets to make them easier to achieve</td>
<td>7%</td>
<td>15%</td>
</tr>
<tr>
<td>Switching from cash to ER stock for retirement plan contributions</td>
<td>7%</td>
<td>11%</td>
</tr>
<tr>
<td>Performing an interim ESOP valuation</td>
<td>10%</td>
<td>6%</td>
</tr>
</tbody>
</table>
HOW ARE ESOPS (ALL INDUSTRIES) PERFORMING (TOP LINE) DURING COVID

<table>
<thead>
<tr>
<th>Expectation of revenue 2020 compared to 2019*</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Flat or up</td>
<td>40%</td>
</tr>
<tr>
<td>Down up to 10%</td>
<td>30%</td>
</tr>
<tr>
<td>Down 10-25%</td>
<td>23%</td>
</tr>
<tr>
<td>Down 25 to 50%</td>
<td>7%</td>
</tr>
<tr>
<td>Down &gt;50%</td>
<td>1%</td>
</tr>
</tbody>
</table>

HOW ARE ESOPS (ALL INDUSTRIES) “FEELING” DURING COVID

<table>
<thead>
<tr>
<th>How has being employee-owned affected your company’s ability to respond to the coronavirus crisis, if at all?*</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Very positive effect</td>
<td>30%</td>
</tr>
<tr>
<td>Somewhat positive effect</td>
<td>36%</td>
</tr>
<tr>
<td>Neutral or no effect</td>
<td>32%</td>
</tr>
<tr>
<td>Somewhat negative effect</td>
<td>3%</td>
</tr>
<tr>
<td>Very negative effect</td>
<td>0%</td>
</tr>
</tbody>
</table>
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

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?
THANK YOU