

REPURCHASE OBLIGATION IMPACT ON THE SPONSOR COMPANY SHARE VALUE

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The valuation procedures related to the sponsor company stock held by an employee stock ownership plan (ESOP) have evolved in recent years. The biggest single change is the emphasis being placed on the future share repurchase obligation of the sponsor company. This discussion describes (1) the need for the valuation analyst’s consideration of this sponsor company obligation and (2) the impact on the employer corporation stock valuation of the alternative ways that the shares of the departing ESOP participants are handled.

INTRODUCTION

One factor that distinguishes employer corporation shares held in an employee stock ownership plan (ESOP) from non-ESOP-owned employer corporation shares in a closely held corporation is the put option associated with the ESOP-owned employer shares.

The put option is a statutory requirement of an ESOP sponsor company. The sponsor company is required to repurchase the distributed employer corporation shares from departing plan participants.

From a plan participant’s point of view, the effect of the ESOP put option is to enhance the marketability and liquidity of the plan participant’s ownership interest—relative to shares of most closely held corporations.

From the sponsor company’s point of view, the economic effect of the ESOP put option is a call on the employer corporation cash flow.

As the typical ESOP matures, the contingent liability associated with the employer corporation ESOP repurchase obligation may reach a point where:

1. the repurchase obligation may affect the ability of the sponsor company to honor the plan put option provision or
2. the repurchase obligation may impair the ability of the sponsor company to achieve its business plan and operational objectives.

The purpose of this discussion is:

1. to explain how the sponsor company management decision regarding how to repurchase the ESOP “put” employer shares can directly affect the employer corporation stock value and
2. to recommend procedures that will allow the ESOP trustee’s financial adviser to include the ESOP repurchase obligation in the annual employer corporation stock valuation analysis.

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REPURCHASE OBLIGATION VARIABLES

The employer corporation repurchase obligation is directly affected by the following factors:

1. the percentage of the employer corporation stock that is owned by the ESOP
2. the specific ESOP plan design features (distribution rules, eligibility requirements, vesting, etc.)
3. other (non-ESOP) repurchase obligations related to a shareholder or other contractual agreement
4. the method used to honor the ESOP employer stock repurchase obligation
5. the sponsor company’s employee census and actuarial variables
6. sponsor company financial variables, such as the sponsor company anticipated growth rates, repurchase

obligation funding vehicles in place, and expected future liquidity needs.

Several ESOP service providers offer repurchase obligation studies. These repurchase obligation studies attempt to quantify the amount of future share repurchases based on certain assumptions of the variables listed above.

A repurchase obligation study can help sponsor company management, ESOP trustees, and financial advisers to quantify and incorporate the repurchase obligation:

1. in the general corporate planning process and
2. in the annual employer corporation stock valuation process.

REPURCHASE OBLIGATION ALTERNATIVES

When shares of employer corporation stock are “put” to the sponsor company by a departing participant, the sponsor company can select one of, or a combination of, the following alternatives to satisfy the repurchase obligation:

1. The sponsor company can redeem the employer shares—referred to as “redeeming.”
2. The sponsor company can recycle the employer shares using sponsor company funds—referred to as “recycling.”
3. The sponsor company can recycle the employer shares using cash already in the ESOP—referred to as “ESOP investing.”

The following sections describe each of the three alternatives a sponsor company can use to honor the employer share repurchase obligation.

Redeeming the Sponsor Company Shares

In applying the redeeming alternative to satisfy the ESOP repurchase obligation, the sponsor company purchases the “put” shares and subsequently cancels them. This option changes the legal ownership of the sponsor company and, therefore, is considered a capital transaction.

The general attributes of the redeeming of the sponsor company shares alternative are as follows:

1. The value of the individual shares, at the shareholder level, does not change (as long as the sponsor company pays fair market value for the shares that it redeems).
2. The employer corporation’s total equity value is reduced by the amount of the stock redemption (which is paid for through additional debt or from sponsor company cash).
3. The redemption of the shares increases each other shareholders’ relative ownership position, so that the redemption is nondilutive at the shareholder level.
4. The sponsor company does not get an income tax deduction related to the redemption, because the redemption is a capital transaction.
5. The stock redemption can affect future employer stock value at the shareholder level; this is because all future value growth (or decline) is concentrated in fewer shares.

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Recycling the Sponsor Company Shares

The recycling alternative is where a plan participant’s shares:

1. are repurchased by the sponsor company and
2. are subsequently contributed to the ESOP as an employee compensation expense.

The employer corporation shares are then “recycled” and later owned by other ESOP participants.

The general attributes of the recycling of shares alternative include the following:

1. The cash used to buy the shares is provided by the sponsor company; the cash is provided either through:
 - a. a company contribution of cash to the ESOP or
 - b. a contribution of employer corporation repurchased shares to the ESOP.
2. The sponsor company contribution to the ESOP is considered an employee compensation expense and, therefore, is tax deductible.
3. The cost of recycling the shares affects the expense structure of the sponsor company, and is, therefore, dilutive to the sponsor company value (versus redeeming the shares).

“The recycling alternative is where a plan participant’s shares (1) are repurchased by the sponsor company and (2) are subsequently contributed to the ESOP as an employee compensation expense.”

- The recycled employer corporation shares are allocated to the remaining participants' accounts as set forth in the plan documents (but, the allocation is generally based on compensation levels).

ESOP Investing in the Sponsor Company Shares

While the repurchase obligation is an obligation of the sponsor company, the ESOP trust may also purchase shares directly from the participant using the plan's own cash balance. This scenario is referred to as "ESOP investing."

The general attributes of the ESOP investing alternative are as follows:

- The ESOP's source of cash would generally be from the sponsor company distributions.
- The ESOP investing alternative is nondilutive; this is because it is a transaction between (a) the ESOP trust and (b) the departing plan participant (i.e., the sponsor company is not a party to the ESOP investing transaction).
- The repurchased shares are allocated to the existing plan participants based on ownership—rather than based on compensation.
- The ESOP investing alternative is generally not tax deductible to the sponsor company.

Table 1 presents a summary of the repurchase alternatives. Table 1 summarizes how each alternative affects the sponsor company from the perspectives of (1) value dilution, (2) relative ownership, (3) allocation of shares, and (4) deductibility for income tax purposes.

REPURCHASE LIABILITY VALUATION IMPACT

Generally, there are four possible ways for the repurchase obligation to impact the value of the employer corporation stock:

- change in operating value
- effect on working capital (or liquidity)
- change in the number of shares
- other "subjective" factors such as the lack of marketability discount, the selected discount rate, and the expected growth rates

The following discussion explains how each of the repurchase alternatives affects the employer corporation stock valuation.

The Value Impact of Redeeming the Sponsor Company Shares

The most significant factors to consider for employer stock valuation as it relates to redeeming include the following:

- projected net cash flow (after considering necessary capital expenditures and investments in working capital),
- the projected number of shares to be redeemed each year, and
- the projected share price for each year.

Table 1
Summary of the Employer Stock Repurchase Alternatives
Expected Impact to the Sponsor Company

<u>Expected Impact to the Sponsor Company</u>	<u>Redeeming of Shares</u>	<u>Recycling of Shares</u>	<u>ESOP Investing in the Shares</u>
Change in total shares outstanding	Yes	No	No
Change in relative ownership %	Yes	No	No
Direct impact to the income statement	No	Yes	No
Shares are cancelled	Yes	No	No
Income tax deductible	No	Yes	No
Dilutive to the per share equity value	No	Yes	No
Reallocates shares to plan participants	No	Yes	Yes
Reallocation is based on	N/A	Compensation	Ownership
Type of transaction	Capital	Expense	Capital

A sponsor company with little operating debt generating cash flow in excess of its repurchase obligation provides adequate liquidity to honor the repurchase obligation. On the other hand, if a sponsor company generates little excess cash flow and has other capital obligations (such as debt payments), then the repurchase obligation may cause a liquidity problem.

The liquidity issue can be reflected in an employer corporation stock valuation by the following:

- Projected working capital.

A sponsor company that anticipates difficulty in funding the future stock redemptions may need to maintain increased levels of working capital. The valuation analyst who uses historical working capital levels or industry average data to estimate future working capital in the financial projections may understate the required increases in working capital.

In this case, it may be appropriate to apply an upward adjustment to the historical or the industry working capital data to account for the employer stock repurchase obligation.

- Discount rate calculation.

In the income approach to employer stock value, net cash flow (1) is projected into the future and (2) discounted to the present by applying a present value discount factor. The riskier an investment is, the higher the required rate of return.

If the sponsor company management anticipates difficulty in funding the share redemptions, then an increased discount rate may be appropriate. The valuation analyst may include the repurchase obligation as one of the factors considered in the company-specific risk premium component of the cost of equity capital calculation.

- Adjusted future growth rates.

A sponsor company's projected earnings are generally positively correlated with the level of the repurchase obligation. As earnings increase, the employer corporation stock value will increase. In turn, the increased employer corporation share value will result in a larger repurchase obligation.

As the repurchase obligation increases, the sponsor company may need to allocate more funds for stock

redemptions—rather than use these funds for growing the core business operations.

The valuation analyst should understand what growth rate factors are considered in the financial projections provided by sponsor company management. It may also be appropriate for the valuation analyst to consider the future call on capital from the repurchase obligation in the long-term growth rate estimate used in the income approach analysis.

- Market pricing multiple selection.

In the market approach to employer stock value, the financial adviser selects a specific multiple to apply to the sponsor company's revenue and/or earnings. This selected pricing multiple is based on market-derived industry pricing multiples.

In determining the appropriate pricing multiple to apply to the sponsor company financial fundamentals, the valuation analyst will generally consider company-specific factors. Such company-specific factors may lead to a higher or lower pricing multiple than the average of the market data.

The call on capital, related to ESOP stock redemptions, is one such factor that the financial adviser may consider in selecting an appropriate market pricing multiple.

- Discount for lack of marketability.

A typical discount for lack of marketability for ESOP employer stock valuation purposes may be in the 5 to 10 percent range.

However, if funding the stock redemptions is likely to be a problem for the sponsor company, then the financial adviser may increase the selected discount for lack of marketability.

“ . . . if a sponsor company generates little excess cash flow and has other capital obligations (such as debt payments), the repurchase obligation may cause a liquidity problem.”

“If the sponsor company management anticipates difficulty in funding the share redemptions, then an increased discount rate may be appropriate.”

The Value Impact of Recycling the Sponsor Company Shares

The most significant factors to consider in the employer stock valuation as it relates to the recycling of shares alternative include the following:

1. the average cash balance maintained by the ESOP plan
2. the average age and the expected retirement rate of the census of the sponsor company workforce
3. the projected number of employer shares to be repurchased each year of the valuation analysis

4. the projected employer share price for each of the valuation analysis years
5. the projected amount of the annual sponsor company cash contribution to the ESOP

The financial adviser can incorporate the recycling alternative into the employer stock valuation by considering the following procedures:

- Make an adjustment to the projected employee benefit expense.

In this procedure, the financial adviser may adjust the projected earnings to reflect the “excess” retirement benefit expense associated with the recycled employer corporation shares.

If the value of the recycled shares is expected to be greater than the amount of the employee benefit expense in the projections, then the excess amount may need to be included in the financial projections.

It is important for the financial adviser to know what level of benefit expense is being included in the projections provided by the sponsor company management.

- Make an adjustment to historical employee benefit expense.

In this procedure, the financial adviser makes adjustments to the sponsor company historical earnings to reflect the recycling policy.

This recycling policy can be included as a downward normalization adjustment to the sponsor company historical operating results.

This procedure inherently includes the repurchase obligation in the employer corporation stock value indicated by the market approach.

- Make a percentage adjustment to the market approach employer stock value indication.

In this procedure, the financial adviser calculates a percentage difference between two income approach employer stock value indications calculated:

1. with normalization adjustments to the employer benefit expense and
2. without normalization adjustments to the employee benefit expense.

Second, the financial adviser applies the income approach stock value indication percentage difference to the unadjusted market approach employer corporation stock value indication. The adjusted (typically decreased) market approach employer stock value indi-

cation considers the impact of the recycling alternative.

The Value Impact of the ESOP Investing in the Sponsor Company Shares

The impact of the ESOP investing alternative is similar to the stock redemption alternative. First, this is because ESOP investing is considered to be a capital transaction. And, second, this is because there is potential for a liquidity issue from future “put” shares.

The financial adviser can include the impact of the ESOP investing through the same procedures that were discussed for the stock redemption alternative.

SUMMARY AND CONCLUSION

The sponsor company repurchase obligation should be considered by the financial adviser as part of each annual employer stock valuation update.

The earlier in the life cycle of the ESOP that the sponsor company and its advisers understand and plan for the repurchase obligation, the less likely it is for the repurchase obligation to have a significant impact on the employer stock value in any single year.

It is important for the sponsor company, the ESOP trustee and the financial adviser:

1. to work together and
2. to understand how the repurchase obligation is considered in the annual employer corporation stock valuation update.

It is likely that the treatment of the ESOP repurchase liability in the employer stock valuations may be an important subject for the U.S. Department of Labor in its audits of the sponsor company ESOP.

Sources:

1. F. A. “Chip” Brown, “The Valuation Impact of the Sponsor Company Repurchase Obligation.” Willamette Management Associates *Insights*, Winter 2007, p. 37.
2. “Repurchase Obligation – Impact on Value” presented at The New South Chapter of the ESOP Association regional meeting October 5, 2007, by David Williams and Kelly R. “Bucky” Wright.

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