



ESOP 201

SANDRA SMITH, ATLANTIC MANAGEMENT COMPANY

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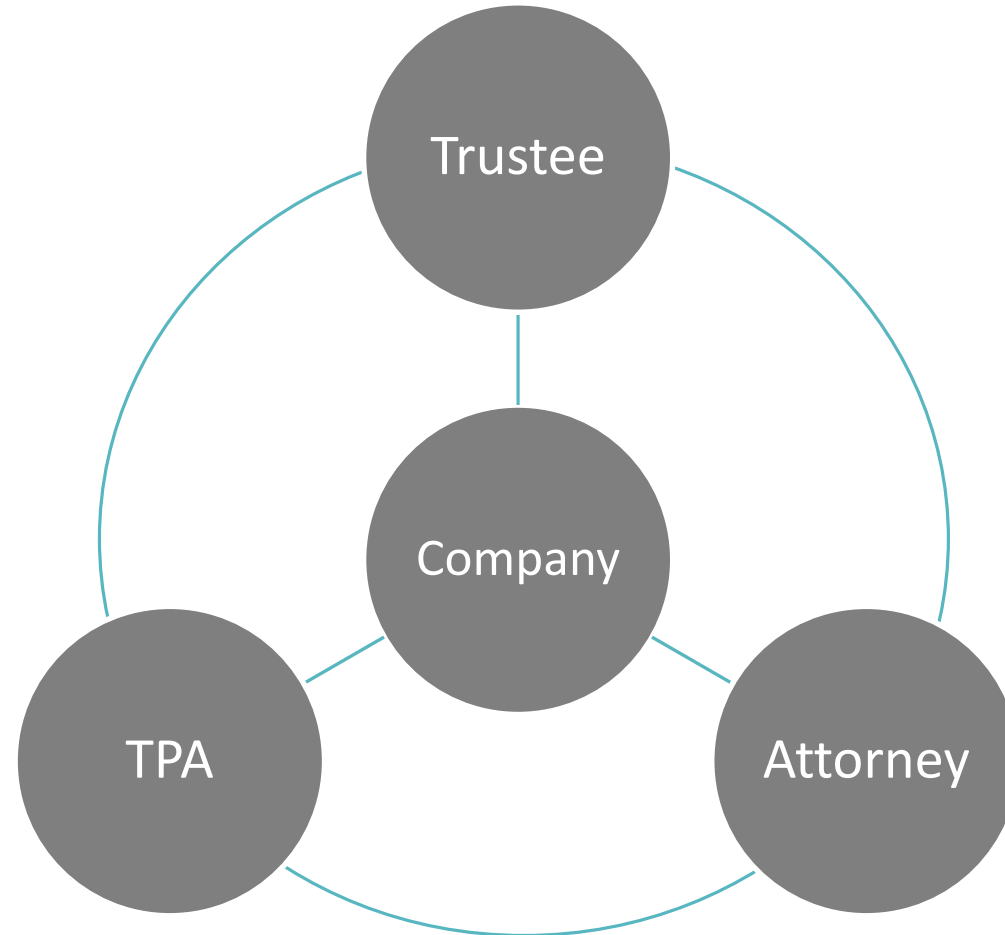
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What Do You Want to Talk About?

Communicating w/Service Providers	Ownership Culture	Fiduciary Issues
Corporate Governance	What Drives Value	ESOP Committees
Repurchase Obligation	Rebalancing and Reshuffling	Distributions and Diversification

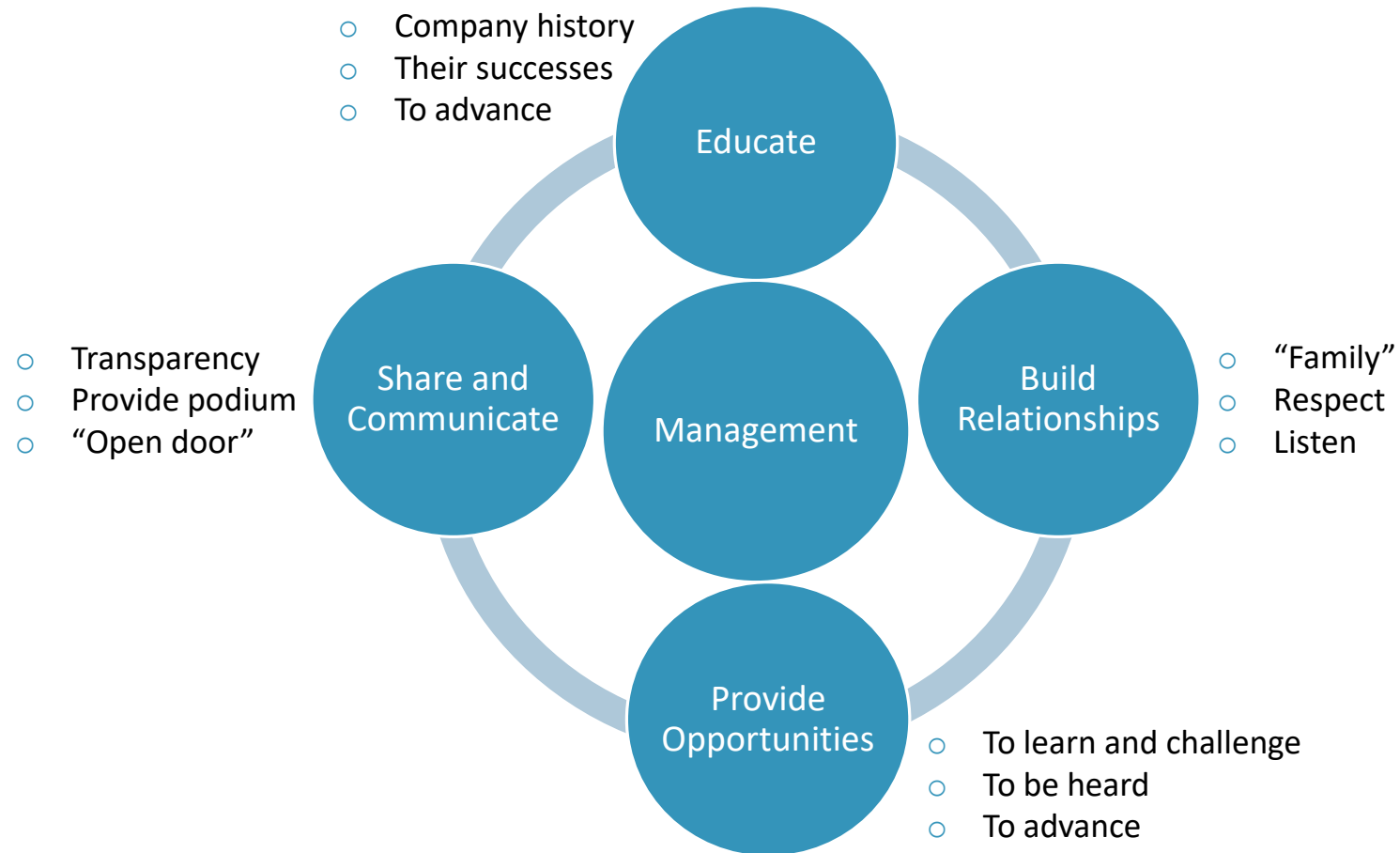
Communicating with ESOP Advisors



Ownership Culture



Ownership Culture - Management



Ownership Culture - Employees



Questions to Ask Financial Advisor Regarding Valuation

- ✓ How did you determine which methods to use?
- ✓ Why did you not use other methods?
- ✓ How did you determine the Cost of Equity, Cost of Debt and Weighted Average Cost of Capital?
- ✓ How did you determine multiples used in comparing to public companies? Are the companies comparable?
- ✓ Is the expected level of capital expenditures and depreciation reasonable?
- ✓ Is the expected level of working capital needed in the future reasonable?
- ✓ Did you tax effect the earnings? If so, how did you determine the rate?
- ✓ Did you include any synthetic equity (SARs, warrants, options, etc.)? How did you account for it?

Questions to Ask Financial Advisor Regarding Valuation

- ✓ What adjustments were made to the reported historical EBITDA? Why? Are they included in the forecast? If so, are they adjusted from it also?
- ✓ Who created the forecast?
- ✓ Does it look reasonable? Why?
- ✓ Are there any non-operating assets or liabilities? How are they factored into value?
- ✓ Is the current level of working capital sufficient? What analysis did you do to determine?
- ✓ Did you consider repurchase obligation?
- ✓ Did you consider the tax shield from the ESOP note?
- ✓ Did you include a marketability discount?

Internal Vs External Trustee

- Required to have a trustee
- Can be internal or external
- Must be educated with the ability to make decisions for the best interest of the plan participants
- Required to act with the care, skill, prudence, and diligence under the circumstances that a prudent man acting in a similar capacity

Internal Trustee

POSITIVES

- Knows your business/company
- Knows the details of your plan quickly
- Easy to access
- Able to help with education and communication
- No additional cost

NEGATIVES

- Lack of proper education
- Busy with full time job
- Conflicted when making decisions since likely a participant and maybe management and even BOD member
- Time consuming
- Risky

External Trustee

POSITIVES

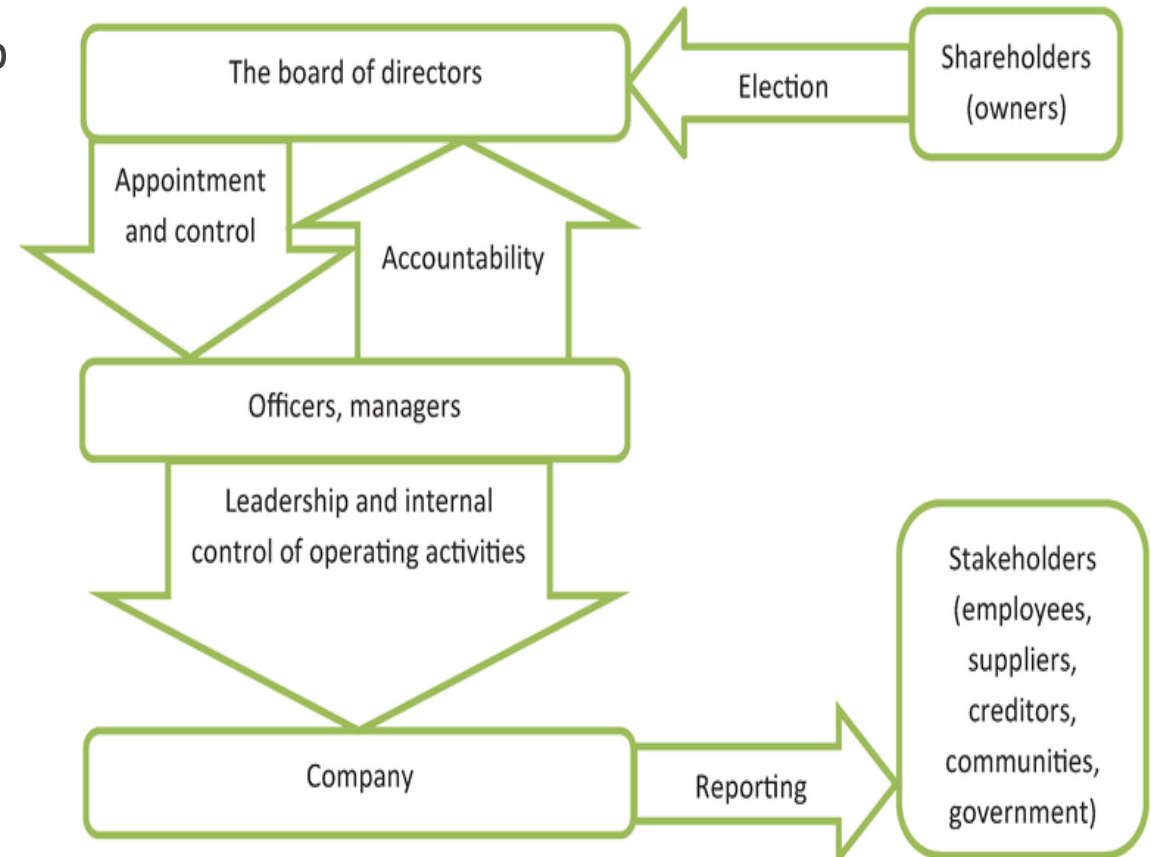
- Independent
- This is our full-time job
- Expertise in role and responsibilities
- Resource to help trouble shoot, suggest options to improve
- Knowledge of the ESOP industry (for example: valuation and how different firms treat a topic)
- Carry fiduciary insurance policy

NEGATIVES

- Only able to see in person a few times a year
- Cost
- Need to research specifics on your plan, since every client is slightly different
- Not an expert in your company

Corporate Governance

- The framework that governs the relationship among shareholders, directors, and officers.
- The shareholders appoint directors, and the directors appoint the officers.
- If ESOP participants have pass-through voting rights, they may direct the ESOP trustee (shareholder).



Credit: <https://www.intechopen.com/books/corporate-governance-and-strategic-decision-making/corporate-governance>

Corporate Governance – Governing Documents

Governing documents:

- Charter or Articles/Certificate of Organization/Incorporation/Formation
 - Establish the legal existence of the entity
 - Establish authorized stock and any preferences, limitations, or restrictions thereon
 - May contain other lawful provisions

Bylaws

- Meetings of the board and shareholders
- Size and election of the board
- Powers and structure of the board and officers
- Amendment provisions
- Indemnification provisions

Governing Documents

CHARTER OR ARTICLES OF INCORPORATION

- Establish the legal existence of the entity
- Establish authorized stock and any preferences, limitations, or restrictions thereon
- May contain other lawful provisions

BYLAWS

- Meetings of the board and shareholders
- Size and election of the board
- Powers and structure of the board and officers
- Amendment provisions
- Indemnification provisions

Sharing Financial Information

- What is open book management?
- Statistics show significant (perhaps 30%) increase in productivity when properly applied
- How much is too much?
- What information should we be sharing?

How is Value Determined?

FORMAL VALUATION

- Report prepared by valuation firm
- Several methods can be used
- Requires financial statements (frequently required to be audited or reviewed), future projections of earnings and cash flows

MULTIPLE OF EBITDA

- Quick and easy method – EBITDA x Multiple
- Requires financial statements (can be internal)
- The higher the multiple and EBITDA = more value

EBITDA = **E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation & **A**mortization

EBITDA Pros & Cons

ADVANTAGES

- Provides a metric to compare two companies (normalizes the metric)
- Interest – doesn't matter if one company has debt and the other doesn't
- Taxes – doesn't matter if one company is a C Corp and the other is an S Corp, or what states they file in
- Depreciation and amortization – removes management estimates

DISADVANTAGES

- EBITDA is NOT defined by accounting standards (U.S. GAAP) and therefore is somewhat subjective
- Does not cover fixed assets or change in working capital
- Is often modified to exclude miscellaneous income or expenses to further “normalize”

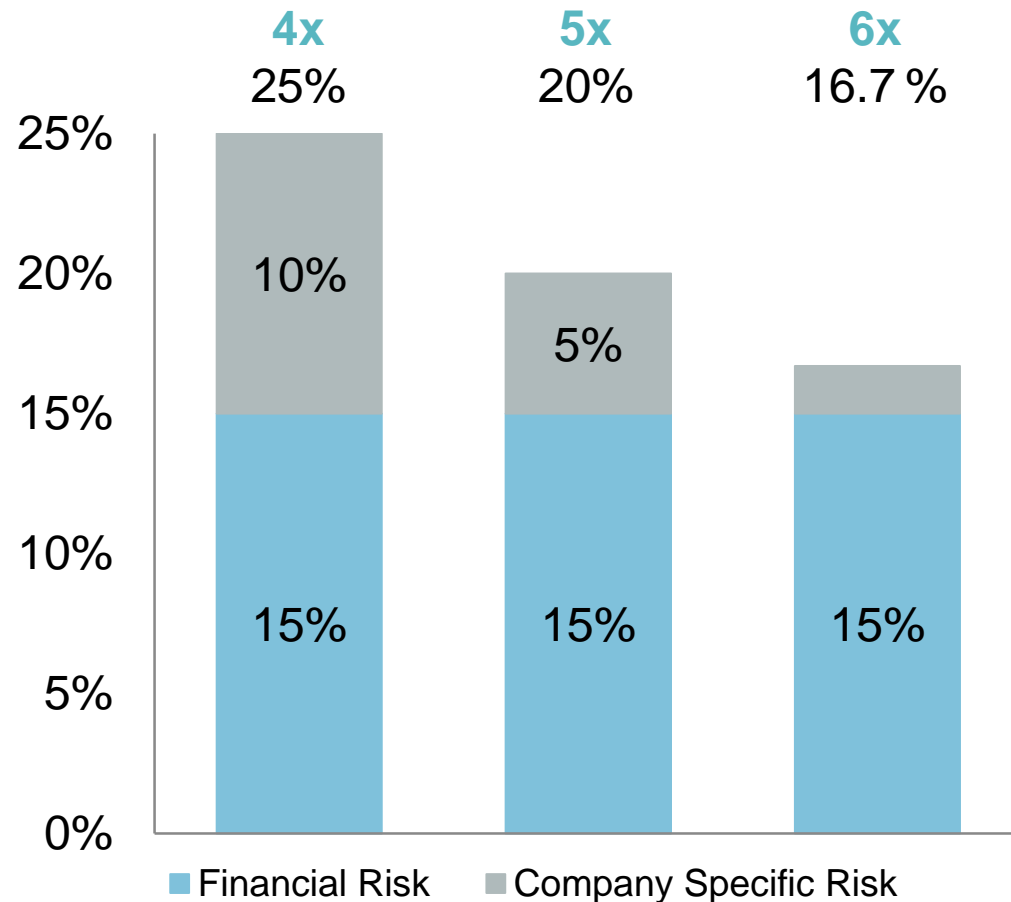
What is a Multiple?

Company Specific Risk

- Volatility of earnings
- Financial performance compared to industry
- Depth of management team
- “Key person” risk
- Customer concentration

Financial Risk

- Treasury rates
- Equity risk premium
- Size
- Debt/equity ratios
- Industry performance



What is Being Valued?

Grow Assets

Basic Balance Sheet

Current Assets	Current Liabilities
Net Fixed Assets	Long Term Debt
	Other Liabilities
Other Assets	Equity

Pay Down Debt

Current Assets	Current Liabilities
Net Fixed Assets	Long Term Debt
	Other Liabilities
Other Assets	Equity

Current Assets	Current Liabilities
Net Fixed Assets	Long Term Debt
	Other Liabilities
Other Assets	Equity

Takeaways

- Every bit of efficiency improvement matters, so speak up!
- Encourage two-way communication
- All of the company's workers working together on common goals results in success
- Provide education and offer group meetings
- Not everyone will get it – how you communicate the information will make or break it
- Communicate often, but don't overwhelm workers with too much information
- Be honest – mistakes happen
- Feedback is a gift, no matter what form it comes in

ESOP Committees

- ESOP Administrative Committee, Plan Committee, or ESOP Committee
- Established by the Board, may have fiduciary obligations
- Charter/operating guidelines
 - Mission statement
 - Objectives
 - Standards
 - Terms
 - Membership criteria
 - Selecting members
 - Responsibilities
 - Meeting frequency and procedures
 - Power and authority

Repurchase Obligation

The obligation the Company has to liquidate participant account balances when they request a distribution of their account balance

- ESOP invested primarily in Company stock, but participant wants cash
- Company stock is not liquid (hence a marketability discount in your valuation)
- Funds to liquidate the stock comes from the Company

Rebalancing

Redistributing cash and stock between participant accounts resulting in all participants holding the same proportion of cash and employer stock.

For example: All accounts are 70% stock and 30% cash

Reshuffling / Segregation

Redistributing cash and stock between participant accounts resulting in all participants NOT holding the same proportion of cash and employer stock.

For example: Active participants have 100% stock and terminated participants have 100% cash

Distributions & Diversification

DISTRIBUTIONS

- Types of distributable events
- Vesting limitations
- When do I actually get paid?

DIVERSIFICATION

- What is it?
- Age 55 *
- 10 years of participation in ESOP *
- Why would I want it?
- Why wouldn't I want it?

* Can be less if elected by the Plan Sponsor