

Repurchase Liability Implications for Stock Value

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This article will provide the reader a summary of the concept of repurchase liability, detail the choices to address and fund the liability, and provide insight into implications on stock value of those choices.

Repurchase Liability

Repurchase obligation, or repurchase liability, is the measurement of a sponsoring employer's responsibility to its ESOP participants to make a market for company shares. Internal Revenue Code Section 409(h)1(b) requires ESOP companies to make a market for shares that are not readily tradeable on an established market. The circumstances under which an ESOP company must make a market include death, disability, retirement, termination, or diversification.

ESOP companies are contrasted with non-ESOP firms in that ESOP companies have the issue of repurchase obligation facing them on an annual basis. Company resources must be devoted to making a market for the employee shares, so management must plan ahead.

What choices are available to an employer to pay the Repurchase Liability?

One way to pay the liability associated with terminated participant shares is to sell the company. In recent years, some Boards of Directors have taken advantage of flattering sale prices to sell their companies. Selling the company for cash also results in immediate liquidity for participant shares. Obviously, not all ESOP

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companies choose to sell in order to fulfill their repurchase requirement. Those who choose not to sell have two alternatives: redeem participant shares, or recycle participant shares. Recycling participant shares is defined as the participant putting shares back to the company, and the company making a contribution or a loan to the ESOP sufficient for the ESOP to pay for those shares. Redemption of participant shares is when a participant puts shares back to the company, and the company redeems the shares, holding them as treasury shares.

Redemption involves a company using its after-tax dollars to buy shares. Cash leaves the firm, and in exchange, the corporation receives shares of stock that will no longer be outstanding for purposes of value allocation. For example, suppose JKL Enterprises is a 100% ESOP-owned company with \$25 million in equity value. There are one million shares outstanding, so the company has a value per share of \$25. Now suppose a long-time participant retires with 40,000 shares valued at \$25 a share. The equivalent account balance is one million dollars.

It does not matter if the sponsoring employer has the cash or has to borrow from a bank to buy the shares. Either way, there is one million dollars leaving the company and going to a shareholder. The company does not get a tax deduction, so the value of the company drops to \$24 million after the redemption. However, this is balanced by a decrease in the number of shares outstanding to 960,000. So the remaining value of \$24 million divided by the 960,000 outstanding shares, results in a \$25 per share value. The redemption is not dilutive on a per-share basis.

In a recycling of the same shareholder interest (40,000 shares valued at \$25 per share), the cost is still \$1 million. In this case, the Board of Directors has decided they want the ESOP ownership to be perpetuated at the current one million shares outstanding level. Therefore, the company makes a \$1 million contribution to the ESOP, which in turn buys the shares. The

benefit to the company is that it receives a tax deduction for the ESOP contribution, potentially saving \$350,000 in taxes. However, the value of the company has dropped by \$1 million. The resulting value of \$24,350,000, divided by one million shares outstanding is a value of \$24.35 per share. The ESOP stock price is lower in the circumstance where the company recycles ESOP shares, versus the circumstance where the ESOP redeems the shares. However, in the case of recycling shares, the remaining participants will get more shares allocated to their account with a possible outcome of an increase in their account balance.

Funding Choices

There are a few different funding choices available for ESOP firms:

- Pay-as-you-go,
- Prefund the liability by making contributions to the ESOP,
- Prefund by holding cash reserves aside on the Balance Sheet, and
- Fund by releveraging the ESOP.

In a pay-as-you-go situation, the company funds the repurchase liability based on its cash resources at the time, or borrows to fund the liability. Management does not set aside cash intentionally, but perhaps factors some estimated amount into the company's annual budget. Pay-as-you-go is satisfactory if the ESOP owns a small percentage of the outstanding shares, or when there are low vested balances. In the circumstance of a 100% ESOP-owned company with significant value growth, managers need to be more proactive in addressing repurchase liability as the share amounts put back to the Company could be significant.

The second and third funding choices are related in that the sponsoring employer is setting up a sinking fund. When a company prefunds the liability by making contributions to the ESOP, it is supporting the ESOPs' repurchase of terminated participant shares, versus having the company redeem the shares. Many companies prefund in this manner.



An alternative to funding the ESOP is to establish a sinking fund on the Balance Sheet of the sponsoring employer. Companies do not make contributions to a benefit plan, but instead choose to segregate cash on the Balance Sheet. This cash is treated as a nonoperating asset, so it is added separately to the going concern value of the business.

The last choice available is not truly a funding mechanism, but rather a means to extend the time it takes to allocate the shares. A company that has a lower percent of shares allocated has a lower repurchase liability since unallocated shares have no repurchase liability. If a plan sponsor pursues a policy of serial share purchases that take place a few years apart, and the shares acquired in those transactions are purchased using debt, then the shares will be allocated over a period of several years. Under such circumstances, the employer may have a sizable percent of shares which are unallocated.

Valuation Basics

Now that we've discussed the subject of Repurchase Liability, let's turn our attention to valuation. There are three basic approaches to valuing companies: the income, market, and asset approaches. Most ESOP companies are valued using income and market approaches, because ESOPs are installed assuming the sponsoring employer will continue as a going concern. Periodically, some ESOP companies may enter into troubled situations where the assets are worth more than the going concern, but for the majority of companies, the going concern value is higher than the asset value.

One important element of the income and market approach is the sponsoring employer's financial performance. The valuator needs to quantify the level of earnings or cash flow that the business has generated, and/or will generate in the future. The second important element in an income or market method is the valuator must determine the market cost of capital. The third element to be determined is the estimated future growth rate of earnings or cash flow.

In a historical income or projected cash flow method, the earnings or cash flow are capitalized or discounted by a cost of capital less a growth rate. In a market method, benchmark pricing from companies with publicly-traded shares are applied to revenue, book capital, earnings, or cash flow characteristics of the subject company. Underlying these calculations is the adjustment of the multiples to reflect contrasts in the costs of capital and growth rates between the public firms and the sponsoring employer. So the income and market approaches, which can be performed using different valuation methods, provide consistent means to value the equity of ESOP companies.

Continuing Employee Benefit Cost

Valuation firms need to consider the continuing employee benefit cost in each valuation. The continuing employee benefit cost, or CEBC, measures the extent to which the company is funding employee benefit plans. The major employee benefits are medical insurance and retirement plans. For purpose of this paper, the focus will be strictly on retirement plan contributions.

The valuation recognizes the CEBC in the income and market methods by reducing earnings and cash flow. CEBC expenses include 401(k) matching contributions, profit sharing contributions, ESOP contributions, and any other benefit plan expense. The CEBC must be included whether a sponsoring employer is recycling or redeeming ESOP stock.

Redemption versus Recycling in alternate Funding Choices, and the Impact on Value

Now the task is to integrate Repurchase Liability concepts with valuation. This is accomplished by examining the repurchase method along with the most common funding



choices. Below are four combinations of funding choice and repurchase methods. The valuation implications of each alternative are examined.

<u>Funding Choice</u>	<u>Repurchase Method</u>
Pay-As-You Go	Redemption
Pay-As-You Go	Recycling
Prefund through the ESOP	Recycling
Prefund through the Company	Redemption

Pay-As-You-Go and Redemption

In a pay-as-you-go system where the employer is redeeming shares, there is no impact on earnings. The act of redeeming shares is not dilutive. But, the proper level of CEBC needs to be included in the Income Statement. In some cases, firms that redeem shares make stock contributions once every few years. If so, the average level of contribution should be factored into the CEBC that is included in the valuation.

Concerning the cost of capital, redemption of shares on a pay-as-you-go basis should have modest impact unless there are very high levels of shares being put back to the employer. The cost of capital could rise if the need for cash for redemptions competes with the company's need to reinvest in its business. And growth might be slowed if high levels of company resources have to be devoted to redeeming stock.

Pay-As-You-Go and Recycling

Recycling under a pay-as-you-go funding system is different, in that the CEBC has to include retirement plan contributions such as a 401(k) match expense in addition to the ESOP contributions. To the extent those benefits end up putting the company's benefit level at an above-market level, this approach may be dilutive unless it leads to extraordinary performance on the part of employees.

The cost of capital and growth may be negatively impacted when a company uses its cash for recycling. The growth of firms

choosing recycling may be lower than a firm that doesn't have a repurchase liability requirement and also may be lower than firms who redeem shares.

Prefunding using an ESOP and Recycling

The next alternative to be examined is recycling while prefunding using the ESOP. From an income standpoint, the CEBC needs to consider the ESOP expense and any other benefit plan contribution. The difference here is that the sponsoring employer contributes more than is necessary to recycle shares in order to fund the ESOP with cash. As was stated earlier, this alternative is more dilutive to per share value than redemption. And, while the cash provides liquidity for ESOP participants, it cannot be used by the sponsoring employer once it is contributed to the ESOP trust.

Just as it was in the pay-as-you-go scenario, the cost of capital and growth may be negatively impacted when a company uses its cash for recycling. Additionally, growth is often negatively impacted because cash in excess of the amount necessary to fund current share repurchase obligations is leaving the company. This cash might otherwise be used to invest in projects to grow the business.

Prefunding on Balance Sheet and Redemption

An increasingly common mechanism to deal with repurchase liability is redeeming stock while prefunding on the company Balance Sheet. In the case of a company with all ESOP shares allocated, the company chooses to replace the ESOP benefit with some other retirement plan contribution. The valuation incorporates the CEBC from these contributions into the earnings or cash flows.

Adding to the going concern value of the company is the cash it is setting aside on its Balance Sheet. The cash improves the liquidity of the company, and gives management the choice of whether to use it for repurchase liability as it intended, or for some other corporate purpose. Cash contributed to the ESOP does not have any flexibility for alternate deployment.



Pursuing redemption with prefunding should have a minimal impact on the cost of capital, and future growth. The employer is establishing a reserve to prevent a liquidity strain caused by share redemptions. Growth might be slowed due to cash being set aside rather than reinvested in the business, but if there were unique opportunities available, management could choose to pursue those lucrative opportunities and reestablish the redemption fund in the future.

Final Thoughts

Generally, the greater amount of recycling in an ESOP firm, the higher the potential for per share dilution. There is a tax benefit associated with the contribution, but it will dilute the share value relative to a case where shares were redeemed into treasury.

On the flip side, the more a company recycles its shares, the better distributed its shares are among its current workforce. And, account balances of the current ESOP participants may be higher due to the reallocation of the recycled shares.

Redemptions are less dilutive, but lead to a concentration of shares in the hands of employees who have been with the firm for many years.

Management must plan for repurchase liability in order to prevent it from harming a company's future growth. Companies growing rapidly need cash to fund growth, and obviously repurchase liability consumes cash. Management must be cognizant of these competing capital uses.

The choice of how to handle repurchase obligation is a far reaching decision. It impacts the value of the company's stock, it impacts the allocation of value between ESOP and non ESOP shareholders, and it potentially impacts the growth of a business. The party charged with the ultimate responsibility to address the repurchase liability is the Board of Directors.

They bear the decision-making responsibility, as the put option of terminating ESOP participants is to the company. So, be sure your Board of Directors carefully considers the implications of the payment and funding alternatives for repurchase liability.

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Mr. Ahern specializes in providing financial advisory and business valuation services to companies in ownership transition. Among these services are: advisory services to firms considering Employee Stock Ownership Plans (ESOPs); valuation advice to owners considering the sale of their business; estate and gift valuation services; and transaction structuring and valuation advice.