

FORECASTING ESOP REPURCHASE OBLIGATIONS



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Roadmap...



- **This presentation starts by addressing some questions that ESOP companies frequently ask about repurchase obligations studies**
- **Then, we'll review the process of doing a study**
- **Finally, we'll give you some tips for getting reliable projections**

Forecasting Repurchase Obligations

- You can't plan for repurchase obligations unless you have an estimate of their size and timing
- A repurchase obligation study is the way you get this information

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Q: Do we have to do a study?

- No legal requirement
- Fiduciary obligation?
- Appraiser might not ask for it
- But . . . how else can you get the information for your long-term planning?

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Q: Do we have to do a study?



The answer should be “yes” if:

- **If the ESOP owns more than 15% - 20% of the company’s stock**
- **The ESOP has been in place > 2 to 3 years**

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Q: When should we do the first study?



- **Ideally, repurchase obligation projections should be part of the initial feasibility analysis**
- **In any event, projections should be done within the first few years after the ESOP is implemented**

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Q: How often do we need to update the projections?

- They should be routinely updated every two or three years
- Projections should be updated more frequently if:
 - The ESOP is considering acquiring additional stock
 - Reality has diverged from the assumptions used in the previous projections

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Q: What information can we get from a study?

- How many shares you will have to repurchase, and when
- How much cash will be needed to repurchase those shares
- The total cash needed for the ESOP
- The stock activity in the trust
- Total covered compensation and a profile of the workforce
- Individual account balances, particularly for large accounts

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Q: How can we use the information?

- Anticipate future liquidity needs
- Develop a funding plan
- Evaluate changes in distribution policies or plan rules
- Quantify the additional repurchase obligations that would result from the ESOP acquiring more stock
- **Avoid surprises!**

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Q: Should we do the study ourselves, or have it done professionally?

It depends...

- **On your resources**
 - ◆ Do you have the time?
 - ◆ The staff with adequate knowledge?
- **On your experience**
 - ◆ With ESOPs
 - ◆ With financial projections

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Q: Should we do the study ourselves, or have it done professionally?

If you do the study yourself, you can run additional scenarios and update results more readily

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Q: Should we do the study ourselves or have it done professionally?

- **Using a consultant does NOT mean "Here's the data, call me when you are done"**
- **You will need to be involved in the process, because your input will be needed to develop the assumptions**

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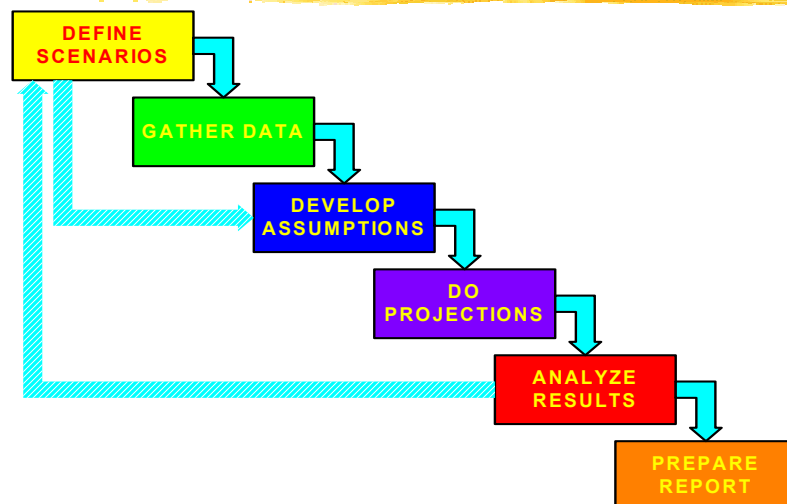
Q: Should we do the study ourselves or have it done professionally?

A consultant brings...

- Experience to the project
 - ◆ Reasonableness of assumptions
 - ◆ Data setup and review
 - ◆ Analytical experience
- The ability to analyze the results and their implications for you

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Q: What's involved in doing a study?



#1: Define the scenarios to be projected

- **What questions are you trying to answer?**
- **What is the likely range of values for key variables?**

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Q: How many years should the projections include?

- **10 to 20 years, or**
- **Long enough to:**
 - **Identify long-term issues**
 - **Allow maximum planning flexibility**

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#2: Gather the data for the study



- **Census information**
- **Business plan and forecasts**
- **Demographic/actuarial information**
- **Plan document**
- **ESOP distribution policies**
- **Valuation report**
- **ESOP loan amortization schedules**
- **ESOP funding plans**

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#3: Develop the assumptions



This is the hard part!!!

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#3: Develop the assumptions



Your assumptions must be:

- Reasonable
- Consistent with other corporate planning
- Internally consistent within each scenario

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#3: Develop the assumptions



Small errors grow large over time!

- What appears logical on its face may not turn out to be, especially over the long term

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#3: Develop the assumptions



4 critical areas to address

- **Plan rules**
- **Demographic/Actuarial**
- **Financial**
- **Funding**

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#3: Develop the assumptions



Plan rules

- **Eligibility and vesting**
- **Retirement age**
- **Timing and form of distributions**
- **Diversification**

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#3: Develop the assumptions



Demographic/Actuarial

- **Group employees with similar characteristics so you can fine-tune assumptions**

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#3: Develop the assumptions



Demographic/Actuarial

- **Turnover**
- **Death and disability**
- **Age and compensation of new hires**
- **Changes in size of workforce**
- **Compensation growth**
- **Exercise of diversification rights**

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#3: Develop the assumptions



Financial

- **Stock value**
- **Loan amortization schedule**
- **Contributions**
- **Dividends**
- **S corporation distributions**
- **Additional stock acquired by ESOP**

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#3: Develop the assumptions



Funding

- **Redeeming vs. recirculating stock**
- **Sources of liquidity for repurchases**
 - ◆ **Pay-as-you-go**
 - ◆ **Sinking fund in ESOP or company**
 - ◆ **Insurance**
 - ◆ **Debt**
 - ◆ **Internal market**
- **Rate of return on other plan investments**

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#3: Develop the assumptions



Consider a range of values for key variables

- **i.e., consider projecting more than one scenario for the most important variables**

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#3: Develop the assumptions



Understand the relationships among variables

- **When developing alternative scenarios, adjust all interrelated variables to maintain internal consistency**

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#3: Develop the assumptions



Get input and “buy-in” from ALL key players

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#4: Do the projections



- **Input your data...**
 - **Build a spreadsheet model, or**
 - **Enter the assumptions into repurchase obligation software**
- **Check your results to make sure that they *make sense***

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Q: Is there software for doing these projections?



Two packages are currently on the market

- **Telescope™ from ESOP Economics**
- **PERLS from BCI Group**

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#5: Analyze the results



Looking for the answers to the questions you had when you developed the scenarios

- **Funding**
- **Additional transactions**
- **Changes in the plan . . . Etc.**

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#5: Analyze the results



- **The results may suggest the need to modify the assumptions**
 - **E.g., relationship between repurchase obligations and value**
- **The process is likely to require several iterations of the projections**

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#5: Analyze the results



Critical questions...

- **How large are repurchase obligations relative to:**
 - ◆ **Cash flow?**
 - ◆ **Earnings?**
 - ◆ **Compensation?**

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#5: Analyze the results



Critical questions...

- **What is the best method of handling repurchases?**
 - ◆ Redeeming shares ,or
 - ◆ Recirculating them in the ESOP, or
 - ◆ Some combination
- **Can they be handled without interfering with growth?**

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#5: Analyze the results



Critical questions...

- **Should changes in the plan or in distribution rules be considered?**
- **What funding methods are appropriate?**

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#5: Analyze the results



Then, if necessary, *redo* the projections with alternative assumptions and/or scenarios

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#6: Prepare the report



The challenge:

- **Going from lots of numbers to something the board of directors can read and understand**

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Q: What information should be in the report?



- **Table of contents**
- **Executive summary**
- **Detailed schedules**
- **Detailed description of assumptions**

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#6: Prepare the report



- **Write an executive summary – in English!**
- **No more than 2 to 3 pages**

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Q: What information should be in the executive summary?



- **Background**
- **Summary of key assumptions**
- **Summary of the results – the key numbers!**
- **Implications**
- **Issues and/or recommendations**

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Some tips for getting good results



Don't wait until the week before the board meeting to start the process!

- **Gathering data**
- **Developing assumptions**
- **Testing scenarios**
- **Writing a report in English**

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Some tips for getting good results



- **Really focus on developing good assumptions**
 - **The whole process will be a waste of time and money if you don't**
- **Involve the key members of management in the process**

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Some tips for getting good results



Look at the results in the context of your business models and forecasts, and adjust assumptions **iteratively, as necessary**

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Remember...



- The projections will only be as good as the assumptions you use – **focus on getting them right!**
- The projections are part of the planning process – not an end in themselves!