

THE “NUTS AND BOLTS” OF FORECASTING REPURCHASE OBLIGATIONS

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Roadmap

- This presentation is intended as a “nuts and bolts” guide to forecasting repurchase obligations
 - What are the practical aspects of doing repurchase obligation projections?
 - What do you have to do to get results that make sense and provide useful information for planning and decision-making?

Definition

- A repurchase obligation study is a *long-term projection* of *ESOP distributions* and the *associated cash requirements* that a company will face
- It is based on assumptions about a number of variables
- It may include multiple scenarios, i.e., projections based on unique combinations of assumptions

Do you have to do a study?

- No statutory or regulatory requirement
- Appraiser might not ask for it
- But . . . fiduciary has obligation to make sure that repurchase obligations can be met

Fiduciary obligation

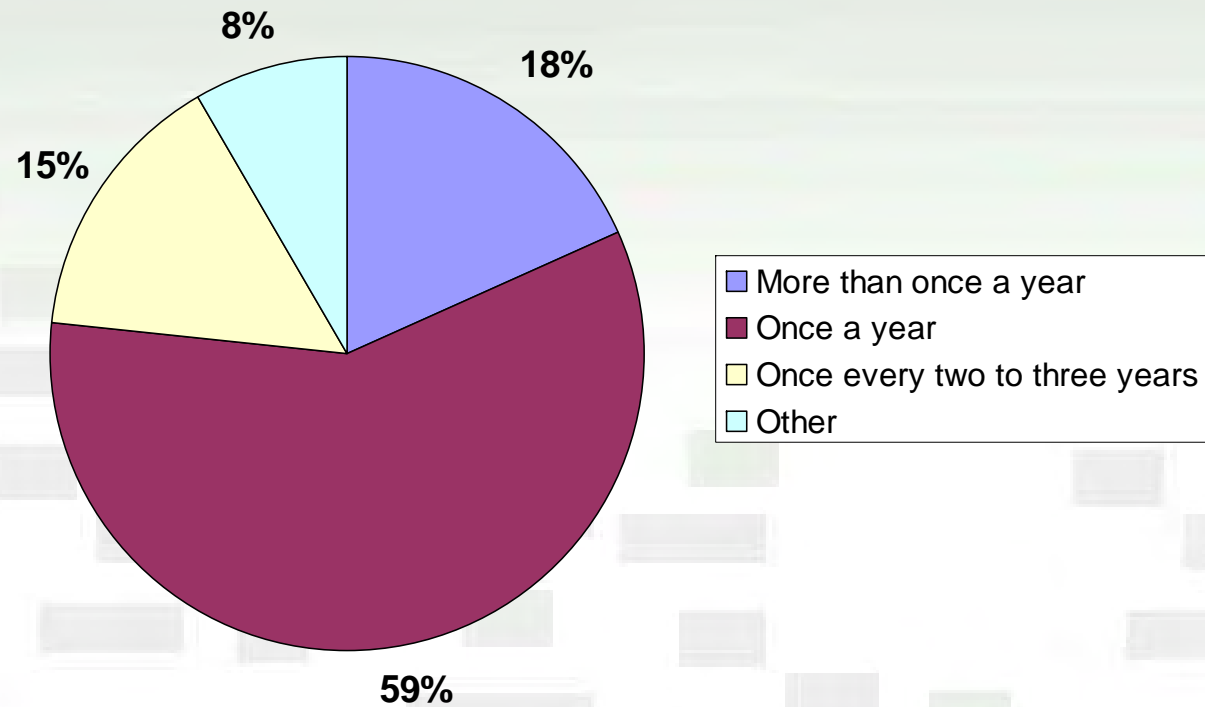
- AMSTED case
 - Fiduciaries had a duty to prudently manage their repurchase obligation
 - Despite fact that repurchase obligation estimates were wrong, there was no breach of fiduciary duty
 - Forecast was based on reasonable assumptions
 - Company had planned for the repurchase obligation and had what appeared to be adequate resources to meet it

When should you do a study?

- Do first study early in the life of the ESOP
- Review assumptions annually
- Update every 2 to 3 years, or sooner if
 - Assumptions or census change significantly
 - ESOP is considering transaction that will affect repurchase obligations

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How often do you do repurchase obligation projections?

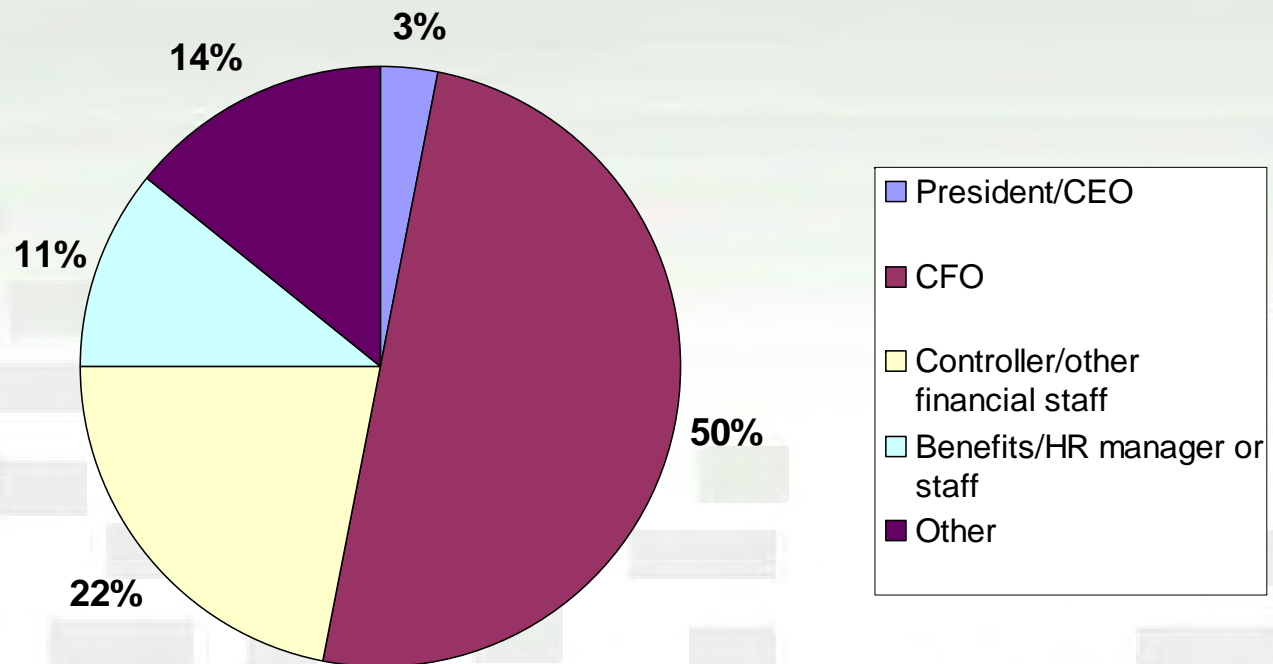


Should you do the study yourselves, or have it done professionally?

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

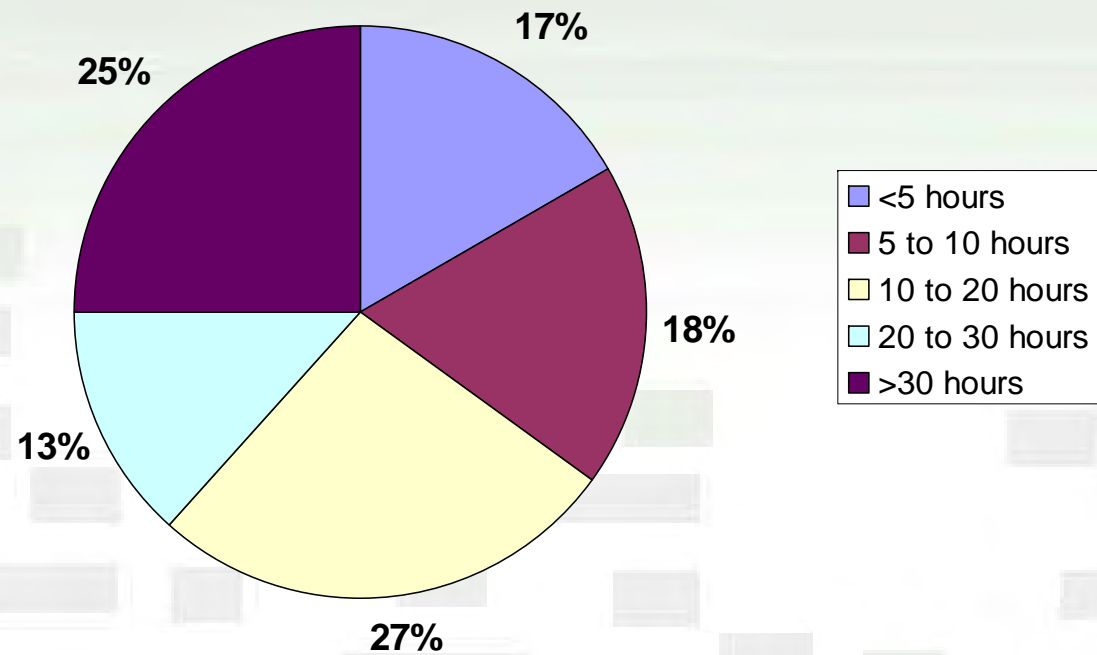
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Who does the projections?



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How long does it take to prepare the study?



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
- Hands-on involvement may provide deeper understanding of repurchase obligation issues

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

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

The forecasting process

1. Define scenarios
2. Acquire software or build model
3. Develop assumptions
4. Do projections
5. Analyze results
6. Project additional scenarios if necessary
7. Prepare report

Step #1 - Define scenarios

- What questions are you trying to answer?
 - How big are the repurchases and when will they occur?
 - Is our current funding strategy adequate?
 - What are the implications of the ESOP acquiring more shares?
 - What are the implications of changing distribution rules?
 - How will an acquisition affect the repurchase obligations?

Step #1 - Define scenarios

- What are the key variables that will affect your projections?
- What is the likely range of values for each of the key variables?
- The goal is to provide information that is needed for planning and decision-making

Step #2 – Acquire software or develop model

- Two software packages are currently on the market
 - Telescope™ from ESOP Economics
 - PERLS from Principal Financial Group
- If you build your own model, it needs to include sufficient level of detail to provide meaningful projections and should include flexibility to vary assumptions

Step #3 - Develop assumptions

- Good assumptions are essential!
- Assumptions need to be:
 - Reasonable
 - Internally consistent
 - Consistent with other financial planning
- Get “buy-in” on the assumptions from key members of management

Step #3 - Develop assumptions

- What data will you need?
 - Census
 - Plan document
 - Distribution policy
 - Valuation report
 - Business plan/financial forecasts
 - Demographic/Actuarial information
 - ESOP loan amortization schedule(s)
 - ESOP funding plan(s)

Step #3 - Develop assumptions

- Assumptions fall into four categories
 - Plan rules
 - Demographic and actuarial assumptions
 - Financial assumptions
 - Funding methods

Step #3 - Develop assumptions

- Plan rules
 - Eligibility
 - Vesting
 - Distribution rules
 - Diversification rights
 - Normal and early retirement ages

Step #3 - Develop assumptions

- Demographic/actuarial
 - Turnover
 - Death and disability
 - Salary growth
 - Changes in size of workforce
 - Age and compensation of new hires
 - Exercise of diversification rights

Step #3 - Develop assumptions

- The smaller the population the more important it is to plan for contingencies, especially for large account balances
 - The smaller the population, the less credible the actuarial projections
 - The smaller the population, the greater the impact of individual events

Step #3 - Develop assumptions

- Turnover is a critical variable
 - Group employees so you can fine-tune turnover assumptions
 - Calculate historical turnover rates
 - Identify factors that may cause variation from historical rates
 - Select or construct an appropriate turnover table for use in the study
 - Test results to make sure table is producing results you expected

Analyzing historical turnover

	<1 YOS	1 to <2	2 to <3	3 to <4	4 to <5	5 to <6	≥6	Overall rate for >1 YOS
Hourly	84%	18%	22%	33%	12%	29%	4%	16%
Salaried	46%	12%	19%	9%	0%	0%	5%	7%
Overall 2003 Turnover								12%

Analyzing historical turnover

Group	Years of Service	2000	2001	2002	2003	Average
< 75K						
	< 4	31%	35%	25%	0%	23%
	4 to 10	20%	17%	0%	0%	9%
	>10	0%	0%	0%	0%	0%
≥75K						
	< 4	10%	11%	14%	33%	17%
	4 to 10	0%	0%	0%	33%	8%
	>10	0%	0%	0%	0%	0%

Step #3 - Develop assumptions

- Financial
 - Stock value
 - Contributions
 - Dividends/S corporation distributions
 - Loan amortization
 - Additional stock acquired by ESOP
 - Rate of return on other plan investments

Step #3 - Develop assumptions

- Stock value is a critical variable
 - Understand methodology used by your appraiser
 - Be consistent with business plan
 - Adjust for ESOP or other debt as appropriate
 - Adjust all related assumptions when adjusting growth assumptions

Step #3 - Develop assumptions

- Small errors grow large over time!
 - What appears logical on its face may not turn out to be, especially over the long term

Step #3 - Develop assumptions

- Funding
 - Redeeming vs. recirculating stock
 - Sources of liquidity for repurchases
 - Contributions
 - Dividends or S corp earnings distributions
 - Other investment accounts in ESOP
 - Company sinking fund
 - Insurance
 - Debt
 - Internal market

Step #4 - Do 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*

Step #5 - Analyze results

- What are the answers to the questions that defined your scenarios?
- What other issues have emerged from the projections?

Step #5 - Analyze results

- How large are repurchase obligations relative to:
 - Cash flow?
 - Earnings?
 - Payroll?

Step #5 - Analyze results

- Should changes in the plan or in distribution rules be considered?
 - Delayed vs. immediate distributions
 - Installment vs. lump sum distributions
 - Redeeming vs. recirculating shares
 - Segregating accounts at termination
 - “Reshuffling” accounts

Step #5 - Analyze results

- What is the best method of handling repurchases?
 - Redeeming shares ,or
 - Recirculating them in the ESOP, or
 - Some combination

Step #5 - Analyze results

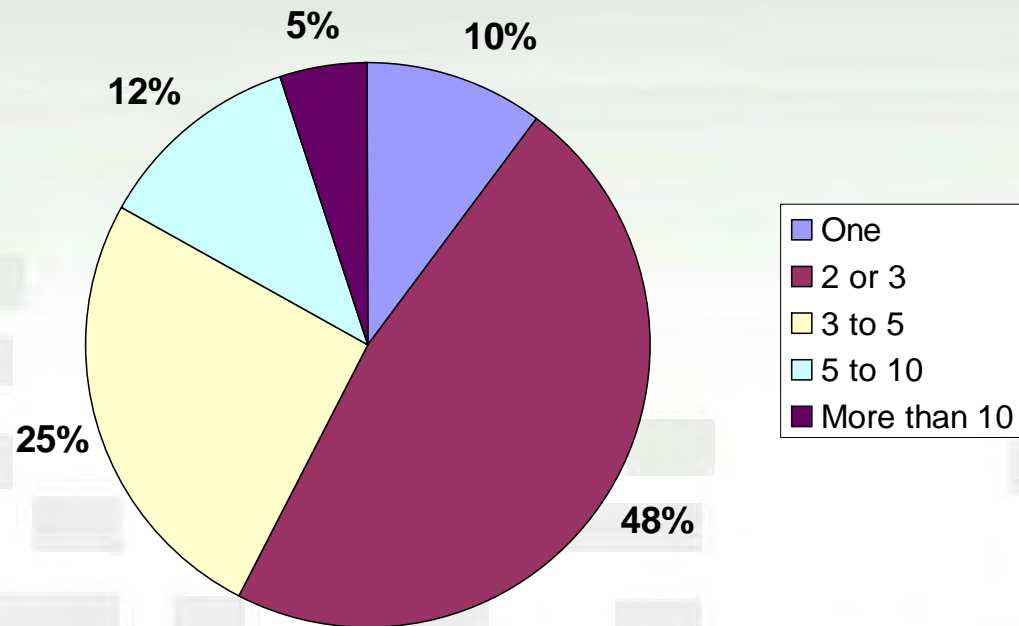
- What funding methods are appropriate?
 - To what extent can repurchases be handled out of current cash flow?
 - Is some sort of advance funding (sinking funds or insurance) necessary and feasible?
 - Will it be necessary to use debt or look to third party solutions to meet the repurchase obligations?

Step #6 – Project additional scenarios

- Initial analysis may suggest additional scenarios that need to be considered
- Test robustness of your repurchase obligation strategy by projecting additional scenarios under more extreme assumptions

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How many scenarios do you actually run?



Step #6 - Prepare a report

- The challenge:
Going from lots of numbers to something the board of directors can read and understand

Step #6 - Prepare a report

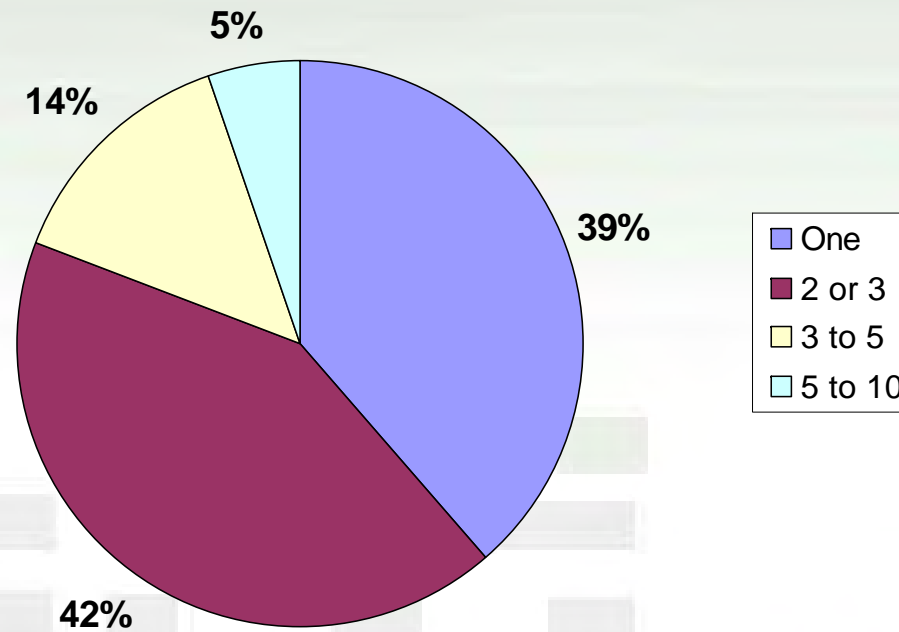
- Write an executive summary – in English!
 - Background
 - Summary of key assumptions
 - Summary of the results – the key numbers!
 - Implications
 - Issues and/or recommendations

Step #6 - Prepare a report

- Also include details of projections and assumptions in your report

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How many scenarios do you include in the report?

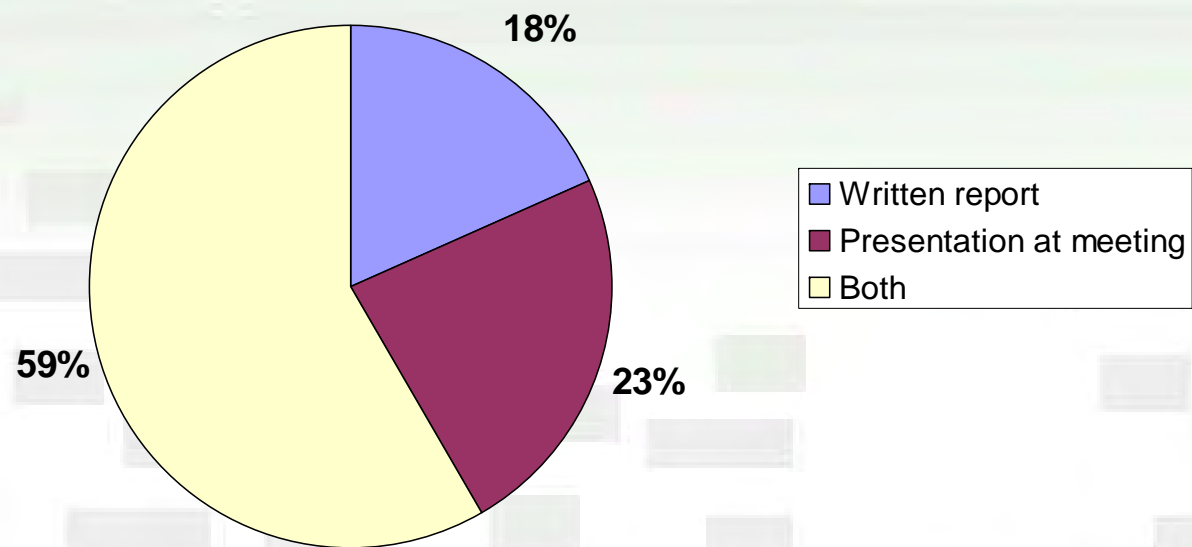


Which schedules should you include in report?

- Projected number of shares to be repurchased
- Projected value of shares to be repurchased
- Projected total distributions to participants
- Sources and uses of cash for the ESOP
- Stock activity
- Demographic activity
- Percentage analysis
- Individual account projections

Survey data

How do you present the study to management/board of directors?



Some tips for getting good results

- Don't wait until the week before the board meeting to start the process! It takes time to do it right.
 - Gathering data
 - Developing assumptions
 - Testing scenarios
 - Writing a report in English

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

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

Remember . . .

- The projections are part of the planning process – not an end in themselves!
- The purpose is to provide information that you can use to plan for, manage and fund the repurchase obligations

In closing . . .

- There is a fiduciary obligation to plan for repurchase obligations
- A repurchase obligation study provides essential information for the planning process
- Focus on developing good assumptions
- A study is not an end in itself – use it to develop a plan