

# Nonleveraged ESOPs

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*Most companies that sponsor ESOPs use borrowed money to finance large stock purchases in a single transaction. However, there are companies that complete smaller ESOP transactions on a year-to-year basis using available cash flow and no debt. Other companies contribute newly issued shares to the ESOP. And still others accumulate cash contributions in the ESOP over time so that a large transaction can be made without borrowing. This article focuses on these latter ESOP strategies where borrowed money is not used.*

**T**he most common ESOP transactions have historically been leveraged transactions, where a company borrows money from a bank equal to at least 30% of the value of the business (in order to meet the 30% ownership threshold for the tax-deferred ESOP “rollover”). The company in turn loans those proceeds to its newly formed ESOP, which the ESOP then uses to buy shares from existing shareholders. Outside funding is typically needed since the “30% Rule” demands a relatively large amount of capital.

Properly structured, this is a conservative strategy that successfully creates broad-based employee ownership and helps create liquidity for shareholders. However, using leverage creates fixed payments that have a priority over almost all other obligations. Therefore, it is important to assess the minimum amount of operating, replacement, and expansion capital a business will need over the repayment period to make sure the company has enough money to achieve its revenue projections.

Another post-borrowing reality is that once a company has tapped a portion of its total debt capacity for the ESOP transaction,

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it concurrently reduces its ability to raise additional capital until the ESOP loan is reduced. This has strategic planning implications if future capital needs involve borrowing.

The combination of a fixed charge and reduced borrowing capacity has led some owners to explore alternative means of creating an ESOP without borrowing. This is true especially among those owners that want to have broad-based employee ownership and who are not driven to sell stock using the ESOP “rollover.”

## **Nonleveraged ESOP Strategies**

In nonleveraged ESOP transactions, either cash or stock is contributed to the ESOP without the use of borrowed money. A company’s board of directors designs and adopts an ESOP and names trustees, just as it does in a leveraged ESOP, taking into consideration all the retirement benefit plan rules and human resource considerations. The nonleveraged ESOP uses one of three structures: (1) the “pay-as-you-go ESOP,” which is funded on a year-by-year basis; (2) the “prefunded ESOP,” which accumulates discretionary contributions for a period of time without an immediate stock purchase; and (3) the “stock contribution ESOP,” whereby the ESOP receives contributions from the company in newly issued shares from the treasury.

### **“Pay-As-You-Go” ESOP Sale Strategy**

Having annual and repeated ESOP stock purchases from existing shareholders is one strategy for creating employee ownership without the use of debt. Using this approach, a company makes a discretionary, tax-deductible cash contribution to its ESOP from available cash flow, which the ESOP uses to purchase shares at fair market value. Fair market value is determined by the ESOP trustee after reviewing an independent appraisal. The law requires an independent valuation to make sure the ESOP does not pay more than fair market value. When the annual valuation update is completed in the following years—which is also a requirement—it can also be used for the next ESOP transaction, should shares become available.

The pay-as-you-go approach provides significant flexibility because there is no minimum or maximum ESOP ownership prerequisite, and owners do not become committed to selling stock in the future. For example, if after completing the initial stock sale to the

ESOP an owner does not want to sell shares again, there is no obligation to tender more shares.

### **Why Sell Stock Incrementally?**

Certain business owners like the idea of smaller, incremental sales better than larger transactions because many are not ready to “get out entirely” and, while they are seeking liquidity, they do not like borrowing. Another appeal of the year-by-year strategy is the gradual nature of this transition. In these situations, owners are likely to consider the outlook for their stock value and the investment alternatives in the marketplace.

Ignoring leverage for the moment, this owner may feel a smaller stock sale is well-timed if the price is not at its “peak” and therefore likes the idea of selling fewer shares today so more shares can be sold at a later date when the price has reached a higher value. Conversely, the owner may be more inclined to sell more shares if the stock is “fully valued” and/or if the company is appreciating more slowly than the investments that will replace the company stock. Of course, a higher stock price will reduce the number of shares that can be purchased with a given contribution.

These outlooks will then be viewed in conjunction with the issues related to leverage in a larger transaction. If debt is either unavailable on acceptable terms or needed for company growth, the owner may not want to tap the company’s debt capacity for this purpose and elect to sell shares in a nonleveraged transaction. Finally, the owner will need to make a fair comparison of the risk associated with the *company stock return* versus a *diversified stock portfolio return* and may find that the risk-adjusted return on company stock is not as good as the return of a (lower risk) diversified portfolio.

Only after considering personal and corporate goals, stock price, and risk-adjusted returns can an owner make a thoughtful choice about selling more or less stock in a leveraged or nonleveraged transaction.

### **A Limitation of the Pay-As-You-Go Strategy**

One limitation to this strategy is the maximum amount of cash that the company can contribute in any given year to its ESOP. While there is no limit on how much *total* stock that the ESOP can accu-

mulate, a company's annual payroll limits will cap each year's ESOP contribution<sup>1</sup> and thus the amount of the annual stock purchase regardless of the amount of profit generated. For example, a company with an eligible payroll of \$3 million may only be able to contribute \$750,000 into the ESOP. Depending on the value of the company, this may be a large or small block of stock.

Companies may be able to increase the size of the annual stock transaction by paying tax-deductible dividends on the ESOP shares if participants elect to have the dividend reinvested in employer securities rather than paid in cash.<sup>2</sup> Each company will have to assess the likelihood of employees reinvesting rather than taking cash, as the tax treatment of the dividend will differ depending on which election the participant makes.

### **Conclusions About Pay-As-You-Go Stock Sales**

The year-by-year sale strategy has become more common because of the reduced capital gains tax rate and the ability of S corporations to have ESOPs as qualified shareholders. These two factors, combined with current tax law that prohibits a tax-deferred sale in an S corporation-sponsored ESOP, preclude the "30% ownership requirement" that the tax-deferred strategy requires and allow sellers to consider smaller transactions, such as the pay-as-you-go strategy. Many owners also like the flexibility and the avoidance of debt that this "to sell or not to sell" approach allows.

### **"Prefunding" ESOP Strategy**

ESOPs funded on a year-to-year basis using discretionary cash—without immediately purchasing company stock—are commonly referred to as "prefunded ESOPs." These ESOPs do not create any fixed funding obligations, as do leveraged ESOPs. Regulations under Section 401(a) of the Code require recurring and substantial contributions to a plan but do not set forth specific guidelines. That said, annual contributions are subject to the same deduction and allocation restrictions as other defined contribution plans based on the combined Code Section 404 and 415 limits, but they do not receive the expanded limits that leveraging permits.

Mechanically, a company's board of directors authorizes the annual cash contribution (as it does for leveraged ESOPs) to the

ESOP, which contribution is in turn invested by the trustee, who is responsible for investing the funds before they are used to purchase company stock. Companies receive an immediate tax deduction for the contribution, even though it is not used to purchase company stock right away. Cash contributed to the ESOP would be allocated to participant accounts in the year of the contribution, just as they are in the leveraged ESOP. As with other defined contribution retirement plans, contributions must be funded by the date the corporate tax return is due (including extensions). Investment returns in the ESOP are untaxed and available to purchase stock when stock becomes available for sale.

### **Why Use the Prefunding Strategy?**

There are several reasons owners might elect to fund their ESOPs in cash for a period of time rather than sell stock at once. Most commonly, the company has performed poorly in the recent past, and the owners are concerned that the current stock value does not reflect its true value. This is a practical consideration, especially if the earnings have rebounded rapidly, since an appraiser may appropriately question the sustainability of the “new cash flows.” If there is some doubt, the appraiser may decrease overall value by increasing risk factors nominally due to the recent history of relatively poor performance. If the preliminary feasibility analysis shows this might be a problem, but the owner has confidence in the future, prefunding the ESOP may be the answer. A company can create the ESOP as a pre-tax depository and allow some time to pass for the share price to reach a more acceptable level for the selling shareholder.

A second reason for prefunding an ESOP is that a company either cannot borrow or does not want to borrow. Some company owners want to reserve their borrowing capacity for projects that will generate a positive cash flow return. Capital used to fund a leveraged ESOP is considered “unproductive” debt by lenders since it is not reinvested in the business and does not generate direct returns that enhance company value. Because every company has a finite borrowing capacity at any point in time—either because it is already leveraged or has only limited capacity to begin with—prefunding can create a flexible way to prepare for a future stock transaction.

Other owners have the debt capacity to fund a leveraged transaction but are unwilling to accept the terms or rates lenders require. Such terms might include a requirement that a seller personally guarantee the debt. Another term might require the seller to pledge the sale proceeds to the lender. In this case, a portion or all of the money realized from the owner's sale are used as a back-up collateral and would be used to satisfy the loan in the event of default. Finally, while some lenders do not require such collateral, they do charge a higher rate of interest, which some owners may not want to pay. Other objections might include loan covenants, change in accounting scope and the oversight and reporting that lenders require.

For S corporations, prefunding the ESOP does not create an obligation to make S corporation distributions to the ESOP *until* the ESOP owns stock. Thus, the owner can have an ESOP, fund it on a pre-tax basis, and not have to make distributions until stock is sold. Of course, once the ESOP becomes a shareholder, it will be entitled to its pro-rata share of distributions just like every other shareholder.

### **Accumulating the Cash**

While prefunding policies for most ESOPs are not predetermined, owners and ESOP trustees generally plan to accumulate cash until there is sufficient capital to either: (1) complete a transaction without using *any* borrowed money, or (2) complete a large sale by combining a smaller loan with the ESOP cash balances. It is a good practice to state this intention in the ESOP adoption resolutions so the game plan is clear to all interested parties and the benefits to the plan participants are made clear.

The most common question relating to this strategy is, "How long can an ESOP accumulate cash before it purchases company stock?" Unfortunately, there is little guidance on this issue. There is nothing in the definition of ESOPs or stock bonus plans that says an ESOP must be immediately invested in shares of company stock or that it must be primarily invested in shares of company stock each and every year. Thus, experts are left to rely on general ESOP principles and good sense to develop rules of thumb.

These principles relate to the purpose of the ESOP and the fact it is *designed* to be invested *primarily* in company stock. Some practitioners believe that *primarily* has meant more than 51% and over

the lifetime of the trust, which creates a basis for accumulating cash for an interim period before owning primary company stock. While there is no unanimous rule of thumb, most experts believe that the prefunding period should not exceed five years, though many would opt for a shorter timeframe.

The primary concern related to a prolonged prefunding period is that such an ESOP may be deemed a de facto profit sharing plan. If this were to happen, and the ESOP used its cash to purchase company stock, the ESOP trustee may have additional fiduciary responsibilities that it would not have otherwise assumed had it used cash to buy or pay for shares from the beginning.

Lastly, though it may be a non sequitur, it is hard to conclude that *company* contributions made to an ESOP for a prefunding period, during which time they will be invested in a diversified and prudent matter, negatively affect employees. The arguments against these benefits may be that (1) the company might have contributed more into another qualified retirement plan if not for the ESOP, or (2) the company value grew faster than the broader investment indexes, which created a lost opportunity cost for employees.

This first criticism is difficult to accept, given the average ESOP contribution tends to exceed the average profit sharing plan contribution. The second criticism is also difficult to accept when one takes into consideration not only returns but also the risk required to generate those returns.

## **Investing the Cash**

During the prefunding period, cash is held in an account called the “other investments account.” This cash should be invested in prudent, diversified securities. Generally, the ESOP trustee will select a registered financial advisor to determine the appropriate investments, after taking into consideration the expected holding period of the cash, future purpose of the money, and the prudence appropriate for a defined contribution retirement plan.

During the prefunding period, contributions to the ESOP are allocated among the accounts of eligible participants in proportion to each participant’s relative compensation, in the same manner as when the ESOP owns company stock. Each year, participants receive their ESOP statements, which will list their two primary accounts—a “company stock account” and an “other investments ac-

count.” In the prefunded ESOP, the “company stock account” balance will read zero (since the ESOP would not yet have purchased stock<sup>3</sup>) and the “other investments account” will show each person’s accumulated cash balance. Other disclosures, including vesting percentages, are also included.

Regardless of the form of the ESOP’s assets at any given time, it is subject to the eligibility, participation, vesting, and distribution rules set forth in the ESOP plan document. Operationally, prefunded ESOPs operate in the same manner as a leveraged ESOP.

### **Prohibited Allocation Rules**

In ESOP transactions involving the deferral of capital gains taxes (the “Section 1042 rollover”), taxpayers who make the deferral election, employees related to the taxpayer making the election, and any more-than-25% shareholder in the company<sup>4</sup> are prohibited from having any portion of the Section 1042 shares allocated to their individual accounts. This restriction does not generally deter a seller, who receives cash for the sale of his or her stock, but can create planning obstacles for related employees and other large shareholders.

In prefunded ESOPs, since participant accounts (including the future sellers) are funded in cash, the prohibited allocation rules during the prefunding period do not apply since there are no Section 1042 shares being allocated. That is, all eligible employees participate in each year’s allocation. However, at the point in time when the ESOP buys stock in a Section 1042 transaction, the seller’s cash balances may not be used in exchange for stock and must remain invested in cash. If stock is acquired in a non-Section 1042 transaction, then the cash account of the seller and other large shareholders can be replaced with stock.

### **The Employee Side of Prefunded ESOPs**

Employees participating in prefunded ESOPs have some benefits and some limitations that their leveraged ESOP counterparts do not. By foregoing the “unproductive” debt of the leveraged ESOP transaction, a company’s financial strength is maintained, which is good for the company and thus its employees. On the other hand, because the prefunded ESOP is not invested in company stock, em-

ployees will not benefit from stock price appreciation, if any, during the prefunding period.

If employers hope to realize productivity gains by creating this ownership opportunity with an ESOP, these factors need to be considered. Some companies eliminate the “stock price problem” by adopting an informal stock appreciation plan outside of the ESOP for all participants that would capture any increases in stock price for all while the plan assets are held in cash.<sup>5</sup> These plans can be structured in many ways, but they all seek to reward the ESOP for share increases while the ESOP assets are held in cash. At the point in time the ESOP purchases shares, using its accumulated cash to buy shares from the seller(s) at fair market value, the company will contribute newly issued shares to match the appreciation gains, if any, during the prefunding period. In this way the employees benefit from the company’s performance during the prefunding period. The ESOP would not hold such rights since they would not qualify as employer securities, but these rights would be an obligation of the company.

### **“What If I Change My Mind?”**

Another common question for prefunded ESOPs is “What if I change my mind?” Company owners that begin funding an ESOP in cash and later decide not to sell stock to the ESOP have several choices for ending their plan. The ESOP can be terminated, and the employee accounts (which become fully vested) are then distributed to the participants. Participants will have the option of rolling over their benefit—without taxes or penalties—into a separate retirement vehicle, such as an IRA or 401(k) plan. Another option available, should the company not wish to grant immediate vesting, would be to merge the ESOP with another qualified defined contribution plan, such as a profit sharing plan. This option is also straightforward, except that the terms of the profit sharing plan need to be at least as generous as that of the ESOP, otherwise, employees may be adversely affected and a plan termination inadvertently caused. For example, if the ESOP accounts fully vest in three years, but the profit sharing fully vests in five, there may be a cutback problem. The solution here would be to either amend the profit sharing plan to accommodate the ESOP’s vesting schedule, or terminate the ESOP and not merge the plans. Both solutions are relatively easy to re-

view and implement, but will require consultation with your ESOP advisor.

### **Conclusions About Prefunded ESOPs**

Prefunding ESOPs can provide a flexible way for companies and owners to prepare for a stock transaction without the use of debt. Though a prefunding period can not last indefinitely, ample time to plan and coordinate a transaction is available to ensure the best outcome for the employees, sellers and company.

### **“Stock-Funded” ESOP Strategies**

Funding ESOPs with newly issued shares is another variety of the nonleveraged ESOP. Using this strategy, a company makes a cashless contribution to the ESOP using newly issued shares. The company determines the share contribution by considering the dollar limits and the percentage of ownership the contribution represents. The result of a stock contribution is ownership dilution and a related tax deduction for the fair market value of the company shares contributed to the plan.

### **Why Contribute Newly Issued Shares?**

Stock funded ESOPs are used by companies whose owners are not ready to sell shares but who are seeking to immediately create broad-based employee ownership. The tax efficiencies and ownership structure of an ESOP allow them to create broad ownership and yet limit the number of total shareholders. Other companies may use treasury shares just as well as new stock contributions to shelter income from taxation. In either case, management has to analyze the employee benefit and corporate finance impacts of contributing shares.

The employee benefit analysis first seeks to determine whether the ESOP is the right tool for creating stock ownership and then examines how the ESOP will fit in with the existing retirement benefit package, including changes that might need to be made. The corporate finance analysis seeks to compare the ownership dilution resulting from share issuance with the value change, if any, that results from increased cash flow.

## **Employee Benefit Considerations of Contributing Shares**

Whenever changes are made to a company sponsored benefit plan, employees take notice, since changes are generally viewed skeptically. Management needs to consider the reaction and impact that funding an ESOP in shares may have on existing benefits and employees' attitudes toward their jobs, especially if management hopes to reap productivity gains.

One factor that influences employee reaction is whether the ESOP will be an added or replacement benefit. For example, a company may simply decide to add the ESOP as a new benefit (which is referred to below as a "new retirement benefit"). In contrast, another company may continue to make matching contributions to its 401(k) plan after adopting an ESOP, but use any discretionary profit sharing contributions to fund the ESOP (which is referred to below as a "replacement retirement benefit"). If existing benefits are replaced, the ESOP should be designed consistently with the existing plan rules so that employees are treated no less favorably than under their existing plan.

Another consideration is management's expectation for the ESOP and whether it will realize a "return" in the form of increased employee productivity the ESOP may yield. Many studies have shown a positive correlation between broad-based employee ownership and increased sales growth, profits, and value.<sup>6</sup> Thus, there is a good reason to think this goal attainable. However, management should assess the current company culture and employee attitudes to determine if the employees can come to understand the opportunity that company stock ownership creates and whether they will begin to vest themselves more fully in the company's financial performance.

After considering these factors, management can move on to assess the corporate finance impact of issuing new shares.

## **Measuring the Impact of New Stock Contributions**

Issuing new shares to an ESOP dilutes existing shareholders' percentage ownership, so it is important to consider whether or not the percentage dilution is offset by any value increase. Unlike a stock dividend or split, a stock contribution to an ESOP creates a non-cash compensation expense, which reduces taxes without an im-

mediate use of cash and therefore enhances cash flow. If the cash is invested productively and generates a return, value might be enhanced. Conversely, if the increased cash flow is not invested productively, then no value is created.

Because funding an ESOP with new shares *will* result in percentage ownership dilution and not necessarily increased value, it is important to consider the factors that enhance value and determine whether a company's financial strength and operating performance are compatible, realistic or possible by using this strategy.

Tables 1 to 4 highlight such differences using a hypothetical company with \$14 million in revenues that is growing at 5% per year and generating net income of 5% per year. The beginning equity value is \$7 million, which is 3.5 times operating income and 10 times net income. This valuation formula is used for the future periods as well. The example further assumes stock contributions equal to 5% of payroll are made to the ESOP each year and that payroll equals 40% of sales. The number of shares needed to make the dollar contribution to its ESOP is then calculated. In the first year, for example, the ESOP contribution equals \$294,000, which equals 4,167 shares, or 4% of the company. In the second year, a contribution of \$308,700 is equal to 4,340 shares, and so on for each of the following years. The same contributions are made each year so that the ESOP owns 18.5% of the business at the end of five years.

The value created by the increased cash flow is calculated by using a 15% return on each year's cash flow increase throughout the five-year example period and then discounting it to a present value. A five-year time horizon was used because the ESOP would accumulate a meaningful ownership percentage and allow for employees to participate over a longer time frame. Given the annual percentage contributions, which average 3.7% per year, the ESOP's total ownership comes to nearly 19%, which also leaves a substantial ownership stake with the original shareholders.

Tables 2 through 4 compare the effect on share value using different contribution scenarios and cash flow returns. Table 2 looks at the impact of issuing shares as a new benefit, table 3 summarizes it as a replacement benefit, and table 4 as a combination of new and replacement benefit. These three funding scenarios also compare the effects of cash flow returns generating no return to the company ("0% Return" in the tables) as well as a 15% return ("15% Return" in the tables.)

## New Benefit Versus Replacement Benefit

The first factor that influences cash flow and value is whether or not the stock contribution is a *new* benefit or a *replacement* benefit. If the contribution is a new benefit, a company would realize a \$0.35 cash flow savings for every dollar contributed to the plan (the expense times the corporate tax rate.) Whereas, if the stock contribution replaces an existing cash profit sharing contribution—which leaves the company—a \$1 stock contribution generates a \$1 of cash savings to the company.<sup>7</sup> Clearly, the company replacing an existing cash benefit will have a greater cash flow than the company adding the ESOP, which will make it easier for the former to generate value than the latter.

Table 2 shows the changes in value over time if the ESOP stock contribution is a “new retirement benefit.” Here, the company’s cash flow increase is equal to \$0.35 for each dollar of stock contributed, since the share contribution is generating a tax deduction and not replacing a cash cost. In year five, the existing shareholder’s stock is worth slightly more if there is no return on the cash flow increase and more if the cash flow savings generate a 15% return. In both cases, however, the existing shareholder’s stock is worth more in the future than at the beginning.

At this ownership level and assuming these performance results, the existing shareholder’s shares are worth \$284,516 more at the end of the example period than at the beginning, assuming the worst-case scenario, which is a zero percent cash flow return. This might be considered a “break even” result for the existing owners since their stock is worth *no less than* before the stock contributions began, recognizing at the same time they might have realized a better return had all the shares been kept to themselves.

Table 3 illustrates the change in value if the ESOP stock contribution replaces an existing cash funded benefit. In this case, \$1 of stock (not cash) contributed to the ESOP creates \$1 of cash flow savings to the company since it replaces an existing \$1 of cash-funded retirement benefit. Generating a 15% return on this cash flow has more of an impact on value over time, as can be seen in the table, and the existing shareholder’s stock value is enhanced by \$1.4 million, as compared to only \$678,000 in the prior example, where the ESOP is an additional benefit.

Finally, the results in table 4 are calculated using a blended contribution scenario in which half of the ESOP stock contribution

**Table 1.**

Summary Operating Performance		Day 1	Year 1
5%	Revenue	\$ 14,000,000	\$ 14,700,000
	EBIT	2,000,000	2,100,000
	<i>EBIT as % of revenue</i>	14.3%	14.3%
	Pretax income	1,076,923	1,130,769
35%	Taxes	<u>(376,923)</u>	<u>(395,769)</u>
	Net income	\$ 700,000	\$ 735,000
<b>Valuation</b>			
	EBIT multiple	3.5	3.5
	PE multiple	10.0	10.0
	Enterprise value	\$ 7,000,000	\$ 7,350,000
<b>Share Calculations</b>			
	Price Per Share before	\$ 70.00	\$ 73.50
	Beginning shares	100,000	100,000
5%	Contribution	\$ -	\$ 294,000
	Newly issued shares	-	4,167
	Ending shares	100,000	104,167
	Price per share	\$ 70.00	\$ 70.56
<b>Ownership Summary</b>			
<b>Share ownership</b>			
	Existing shareholders	100,000	100,000
	ESOP	<u>-</u>	<u>4,167</u>
		100,000	104,167
<b>Value of shares</b>			
	Existing shareholders	7,000,000	7,056,000
	ESOP	<u>-</u>	<u>294,000</u>
		7,000,000	7,350,000
<b>% Ownership</b>			
	Existing shareholders	100.0%	96.0%
	ESOP	<u>0.0%</u>	<u>4.0%</u>
		100.0%	100.0%

**Basic Scenario**

	Year 2	Year 3	Year 4	Year 5
\$	15,435,000	\$ 16,206,750	\$ 17,017,088	\$ 17,867,942
	2,205,000	2,315,250	2,431,013	2,552,563
	14.3%	14.3%	14.3%	14.3%
	1,187,308	1,246,673	1,309,007	1,374,457
	(415,558)	(436,336)	(458,152)	(481,060)
\$	771,750	\$ 810,338	\$ 850,854	\$ 893,397
	3.5	3.5	3.5	3.5
	10.0	10.0	10.0	10.0
\$	7,717,500	\$ 8,103,375	\$ 8,508,544	\$ 8,933,971
\$	74.09	\$ 74.68	\$ 75.28	\$ 75.88
	104,167	108,507	113,028	117,738
\$	308,700	\$ 324,135	\$ 340,342	\$ 357,359
	4,340	4,521	4,710	4,906
	108,507	113,028	117,738	122,643
\$	71.12	\$ 71.69	\$ 72.27	\$ 72.85
	100,000	100,000	100,000	100,000
	8,507	13,028	17,738	22,643
	108,507	113,028	117,738	122,643
	7,112,448	7,169,348	7,226,702	7,284,516
	605,052	934,027	1,281,841	1,649,455
	7,717,500	8,103,375	8,508,544	8,933,971
	92.2%	88.5%	84.9%	81.5%
	7.8%	11.5%	15.1%	18.5%
	100.0%	100.0%	100.0%	100.0%

**Table 2. Example of Value Changes Using an ESOP as a New Retirement Benefit**

	New Retirement Benefit			5 Year Avg. Annual Return	
	Initial Value	0% Return	15% Return	0% Return	15% Return
Existing	\$ 7,000,000	\$ 7,284,516	\$ 7,678,387	0.8%	1.9%
ESOP	-	1,649,455	1,738,640		
Total	7,000,000	8,933,971	9,417,027	5.0%	6.1%

**Table 3. Example of Value Changes Using an ESOP as a Replacement Retirement Benefit**

	Replacement Retirement Benefit			5 Year Avg. Annual Return	
	Initial Value	0% Return	15% Return	0% Return	15% Return
Existing	\$ 7,000,000	\$ 7,284,516	\$ 8,409,862	0.8%	3.7%
ESOP	-	1,649,455	1,904,270		
Total	7,000,000	8,933,971	10,314,132	5.0%	8.1%

**Table 4. Example of Value Changes Using an ESOP as a Part New/Part Replacement Benefit**

	Part New/Part Replacement			5 Year Avg. Annual Return	
	Initial Value	0% Return	15% Return	0% Return	15% Return
Existing	\$ 7,000,000	\$ 7,284,516	\$ 7,847,189	0.8%	2.3%
ESOP	-	1,649,455	1,776,863		
Value	7,000,000	8,933,971	9,624,052	5.0%	6.6%

is made in newly issued shares and half is made as a replacement benefit. This scenario might be more realistic, since companies may not want to fully replace a discretionary profit sharing benefit. Not surprisingly, the results are better for everyone than in the first scenario but not as good as in the second.

In all three examples (tables 2 through 4), the existing shareholder's stock is worth more at the end of the example period than it is today. However, these results vary depending on whether the ESOP is a "new retirement benefit," a "replacement retirement benefit," or "part new/part replacement benefit," and whether the cash flow savings generates a continued return or not. There are additional factors, discussed below, that affect these results, so it is important to take all of these into consideration, as well.

## Cash Flow Returns

Theoretically, a company with a *growing*, sustainable cash flow will be worth more than a company with a *stable*, sustainable cash flow. It is not difficult to make the case that certain ESOP stock contributions may increase cash flow and therefore value. However, appraisers may have differing views on what the appropriate return rate for that cash—if any—should be. Some suggest that any value increase will already be reflected in the reduced term debt that the incremental cash helped to “prepay.” Others believe that if the cash flow is identifiable and material, a rate return can be attributed to the cash flow savings. Yet others have suggested there is no value attributable to the issuance of shares to the ESOP since shares have to be repurchased in the future.

## Company Size

It is easier for a larger company to create a stock-funded ESOP than a smaller company, since \$100,000 contributed to a \$7 million company is quite different from \$100,000 contributed to a \$1 million company. It would not take long for the smaller corporation’s ESOP to own a very large position in the company if it made 10% stock contributions year after year. While it could contribute shares based on a “percentage ownership calculation” rather than a “dollar formula,” it may turn out that the total dollar amount of the benefit is not large enough to create enough interest in the employees eyes and therefore not create the productivity incentives that are sought.

## Stock Price Performance

It is less dilutive to shareholders for a company to contribute shares to the ESOP if their stock value is appreciating rapidly, since each year’s dollar contribution will require fewer shares and therefore a lower percentage of ownership dilution to begin with. Similarly, it is relatively more dilutive for a company to contribute shares to the ESOP if their stock price is flat. In that case, contributing dollars requires more shares, and thus a higher percentage of ownership dilution.

## **Capital Structure**

A company's capital structure has an effect on the result of contributing newly issued shares to an ESOP. A company's equity value will reflect its debt position. If a company is leveraged and its debt capital is not permanent, its equity value will be (temporarily) depressed by the existence of that debt. Contributing shares when the stock price is "low" requires more shares per dollar and thus more percentage ownership dilution. If the debt is indeed temporary, owners might consider waiting until the debt is repaid so the equity value is restored and fewer shares-per-dollar are needed.

## **Conclusions About Stock-Funded ESOPs**

There are some general rules of thumb to go by when considering a stock-funded ESOP; these rules include:

- It is easier to generate value by issuing shares if the ESOP contribution is, at least partially, replacing an existing discretionary cash-funded retirement benefit.
- Value created from the cash flow increase must be assessed carefully.
- Companies that are carrying a lot of debt will suffer greater dilution than those without debt.
- The faster value is growing, the less dilutive it will be for owners to contribute stock.
- The larger the dollar contributions, the greater the dilution.
- The smaller the company, the more difficult it is to develop a balanced plan.
- Because the value assumptions are an important part of this strategy, one should analyze the stock funding plan by developing a valuation model and guidelines to assess the impact on value from issuing new shares.

## **Where Does That Leave Us?**

As you have no doubt heard before . . . it depends! Every company and company owner is different and has certain liquidity needs,

investment horizons, and management succession issues. The first place to start when assessing a nonleveraged ESOP is with a detailed financial analysis. This will allow management to assess the impact on company value, ownership dilution, and borrowing issues. Next, the non-financial factors should be considered and a comparison made with the financial results. After completing this exercise, the owners and management will be able to determine what type of ESOP transaction is best suited for the owner and most compatible for the company.

While leveraged transactions are likely to remain the most common type of ESOP, there are many circumstances where a nonleveraged ESOP creates a better result for existing owners, their company, and employees than the leveraged ESOP. So don't give up on the ESOP idea if leverage is not an option—there are at least three different ways to establish a successful ESOP in a nonleveraged manner.

## Notes

1. Section 404(a) of the Internal Revenue Code (the “Code”).
2. Section 404(k)(A)(iii)(II) of the Code. This provision allows for a deductible dividend if the participant elects to have his or her dividend reinvested in qualifying employer securities, but it is not deductible if he or she takes the dividend in cash.
3. This assumes the ESOP does not already own company stock.
4. Section 409(n)(1)(A) of the Code.
5. Such a plan would be considered “synthetic equity” under the Section 409(p) anti-abuse rules for S corporation ESOPs. That said, if the plan is broad-based, it would not likely create nonallocation year problems.
6. See *Employee Ownership and Corporate Performance* (Oakland, CA: NCEO, 2004), which reviews dozens of studies on the subject; Rosen and Quarrey, “How Well Is Employee Ownership Working?”, *Harvard Business Review* 65 (1987) (summarized in *Employee Ownership and Corporate Performance*), and also “Unleashing the Power of Employee Ownership,” *Hewitt Associates*, 1999.
7. This illustration ignores the repurchase obligation for simplicity, since the timing and magnitude of this cost is highly dependent on company specifics, such as stock price changes, employee demographics, and the percentage of ownership, among others.

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The *Journal of Employee Ownership Law and Finance*, which is published quarterly by the National Center for Employee Ownership (NCEO), explores the legal and financial issues surrounding employee ownership in a manner accessible to both the layperson and the specialist. It is the only professional journal in the U.S. solely devoted to employee ownership.

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