ESOP ECONOMICS
REPURCHASE OBLIGATION EXPERTS

MAKING THE BUBBLE WORK

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Oxygen Service Company (OSC) was facing a period of extremely high repurchase obligations. They needed a strategy that was sustainable for at least 15 years based on current forecasts, and that avoided problems caused by redemptions. Based on a thorough analysis of OSC's situation and alternatives, ESOP Economics created a strategy that not only met OSC's long-term goals, but could be easily tweaked as distributions and demographics evolved.

OSC is the largest independent welding supplies distributor in the Upper Midwest. They had been performing annual ESOP repurchase obligation (RO) projections with ESOP Economics' Telescope™ software. Their projections indicated a 10-year period of very high ROs, as the participants who had rolled over balances from the profit sharing plan reached diversification and retirement. About mid-way through that "bubble", they realized that the strategy they had been using was not meeting their goals.

"We had a situation we knew needed to be solved," said Bob Olsson, CFO. "We realized ESOP Economics had the expertise to help us."

OSC sought a strategy that, based on current forecasts, was sustainable over at least a 15-year period, avoided "lift" in share value, and eliminated piecemeal year-by-year decision-making about how to handle repurchase obligations.

A THOROUGH PLANNING PROCESS

ESOP Economics started by auditing the Telescope study that Bob had prepared to confirm everything was being modeled correctly. Then they created a 20-year financial model incorporating valuation metrics that mimicked how OSC's independent appraiser was valuing their stock. ESOP Economics integrated repurchase obligations into the financial model and developed the base case.

"It was a quick startup. The ESOP Economics team reviewed our Telescope study to verify what we had was accurate and reliable, and gathered additional info they needed from us. They went through our plan with a fine-toothed comb," Bob Olsson.

INITIAL FINDINGS

OSC was facing large repurchase obligations for the next five years—the "bubble" years—as a result of two significant structural factors:

1. Demographics: around 57% of the shares in the ESOP were in the accounts of participants 55 and older. Repurchases during those years would average around 12% of the shares in the ESOP annually!

2. High equity value relative to covered compensation of the ESOP participants — normal for a distribution business.

OSC had been funding its ESOP with 15% annual contributions, and redeeming shares when repurchases exceeded contributions. The projections showed that repurchases couldn't be funded within the IRC 25% contribution limit, let alone within the 15% target contribution level OSC had established. If they continued their current strategy, only one third of the shares would remain in the ESOP at the end of 15 years. Also, there would be a significant lift in share value – value per share would grow more than twice as fast as equity value. The good news was OSC had the cash flow to cover repurchase obligations – it was just a matter of figuring out an optimal strategy.

ESOP Economics looked at maximizing contributions at 25% of covered compensation and explored two different ways of covering the shortfall: redemptions and S distributions. Both scenarios had similar cost over the 15-year period. However, the large repurchases during the bubble had a compounding component. The lift in share value or the S distributions significantly increased the size of the accounts of participants closest to retirement. The challenge was to avoid that, and reduce the overall repurchase obligations.

A STRATEGY FOR SUCCESS

That's when ESOP Economics proposed releveraging to make the bubble work to OSC's advantage by moving a significant number of shares into loan suspense. During the bubble years, repurchases would be handled by redeeming shares, which OSC would immediately sell back to the ESOP with a loan – ideally with a very long amortization schedule. Annual contributions release shares from loan suspense, at which time the shares are allocated to participant accounts.

This controls the reallocation of shares from repurchases, avoids a lift in share value, and lowers repurchase obligations through fewer shares in participant accounts.

"The software, Telescope, was an excellent tool, but ESOP Economics' expertise was what we relied on throughout the process."
—Bob Olsson, CFO

"This concept that ESOP Economics brought to our attention of releveraging internally between the trust and the corporation and setting up loans accordingly was a very sound solution, financially as well as keeping things stable with the trust itself," said Olsson.

To educate the Board, ESOP Economics modeled several different combinations of contributions, S distributions, redemptions and releveraging.

RELEVERAGING STRATEGY RESULTS

ESOP Economics created a five-year plan to handle repurchase obligations through redemptions and sell shares back to the trust with loans (25 year loan amortization schedules). During this period, 15% cash contributions would be made to the ESOP to maintain benefit levels and cover loan payments and some repurchases. The goal was to move about 35% of the shares into loan suspense – an optimal level based on the analysis. Year 6 on, all shares would be recirculated. Cash contributions would be increased to 25%, including loan payments, and S distributions would be used for shortfalls.

Releveraging reduced overall repurchase obligations costs, created more manageable and less variable repurchases, and avoided the problems redemptions had been creating.

OSC now has a 5-year game plan that gives the BOD direction on how to fund the repurchase obligations during the bubble. It also provides a tentative strategy beyond that for the next generation that is equitable and sustainable.

"We're always thinking of the future generations that have to keep the ESOP moving forward," says Olsson. "With ESOP Economics' help and their software's capabilities, and accurate reliable suggestions guiding us along, we've been able to accomplish that."