



AMERICAN WORKING CAPITAL

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*Facilitating Employee Ownership*



# Ohio Employee Ownership Conference

## Comments on Valuation/Repurchase Liability Issues in ESOP Sustainability

April 17, 2009 Panel Discussion



# Why Repurchase Obligations Matter



Repurchase Obligations and Valuation are two important issues for ESOP Sustainability

- RO and Valuation are also intertwined (i.e., iterative)
- Need to be considered together

How an ESOP company deals with its repurchase obligations may affect

- Company expense structure
- Employee benefits
- Allocation of employee benefits
- Company cash flow and cash/debt balances
- Share price
- Investment/corporate finance decisions
  - Future PPE investments
  - Acquisitions
  - New product development



# Start with Valuation: How Should Repurchase Liability Affect a Valuation?



There are 4 Possible Valuation Effects:

1. **Operating Value** can change  
(if is there an additional employee benefit offered)
2. **Balance Sheet** (or liquidity) effects
3. **Capital Structure** effects as **number of shares** outstanding may change
4. Other “subjective” effects (DLOM, discount rate, growth rate)

Now consider the 2 primary ways a Company can deal with repurchased ESOP shares:

- **Redeem** into Treasury (meaning retire the shares)
- **Recycle** back to ESOP through a contribution

Companies can apply either, or both, methods to repurchased ESOP shares

Each method (Redeem vs Recycle) has very different:

- Valuation impacts
- Employee Benefit results
- Company cash balances



# How Does Redemption Work?



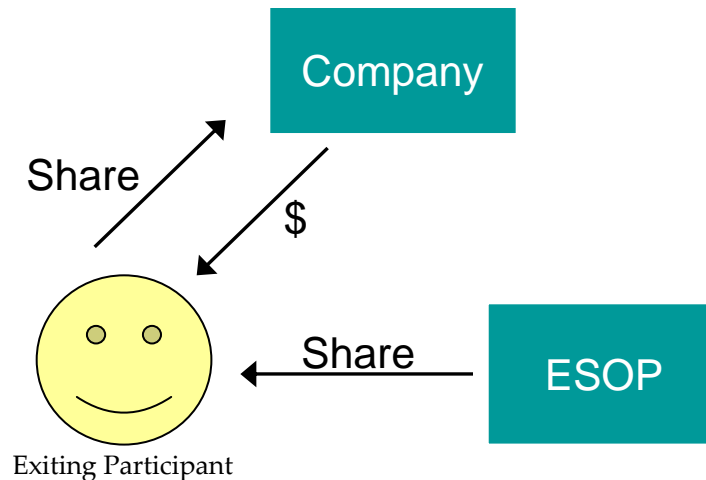
The Company repurchases ESOP shares from employees

The ESOP shares are put into Treasury (Redeemed)

Effects are:

- Lowers the Total Company value as \$ paid out (**Balance Sheet effect**), but also
- Lowers the Number of Shares outstanding (**Capital Structure effect**)

However, the 2 effects exactly cancel each other out, so the net effect is \$0 change in PER SHARE value (with caveats)\*



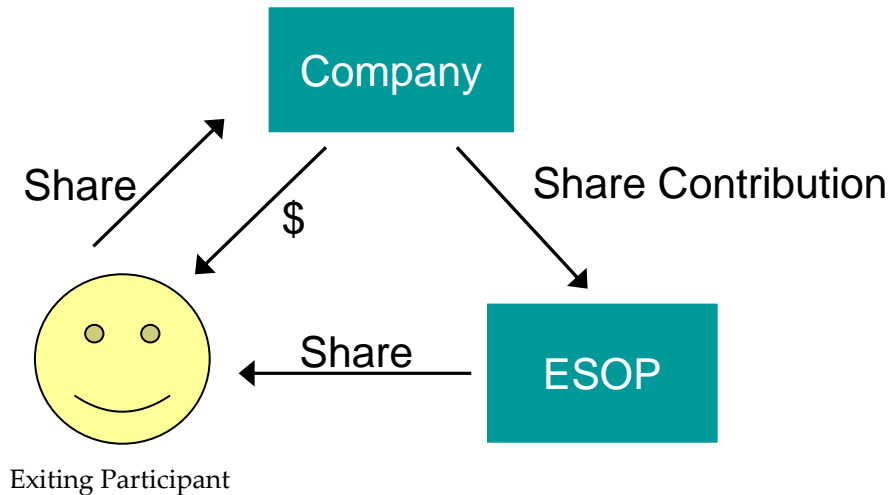
- \*2 Caveats are: (1) Assumes correct values paid for shares; and  
(2) Assumes company has adequate liquidity after share redemptions



Company repurchases shares from Employees, paying cash or debt

Rather than retiring into Treasury, the Company contributes the shares (or cash used to buy shares) back to ESOP

Contribution is part of a deductible benefit program (up to normal limits)



Recycling has a direct impact on company's Operating Value this time! (with 1 Caveat)\*

- **Recycling (versus not recycling) changes a company's cost structure**
- Plus has all impacts listed for Redemption too (liquidity, growth, ...)

\* Caveat 1 - Benefit Substitution

- If recycling is in place of another, identically valued benefit (i.e., a benefit substitution), then cost structure does not change



## Simplified case study of 100% ESOP-owned company

- 3% annual revenue and EBITDA growth
- ESOP puts begin in 2008 after ESOP debt is repaid
- All puts to company are for cash
- Company has adequate benefits without the ESOP
- 5% of each year's allocation is put each year

## Conclusions reviewed

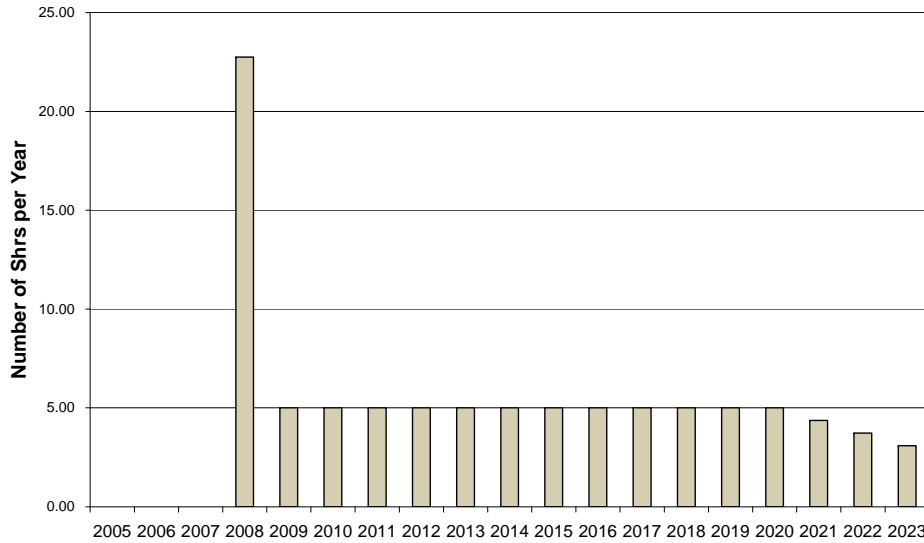
- Total equity value, and growth over time
- Stock price growth
- Company cash balance



# Example 1: 100% Redemption Share Puts and Number of Shares

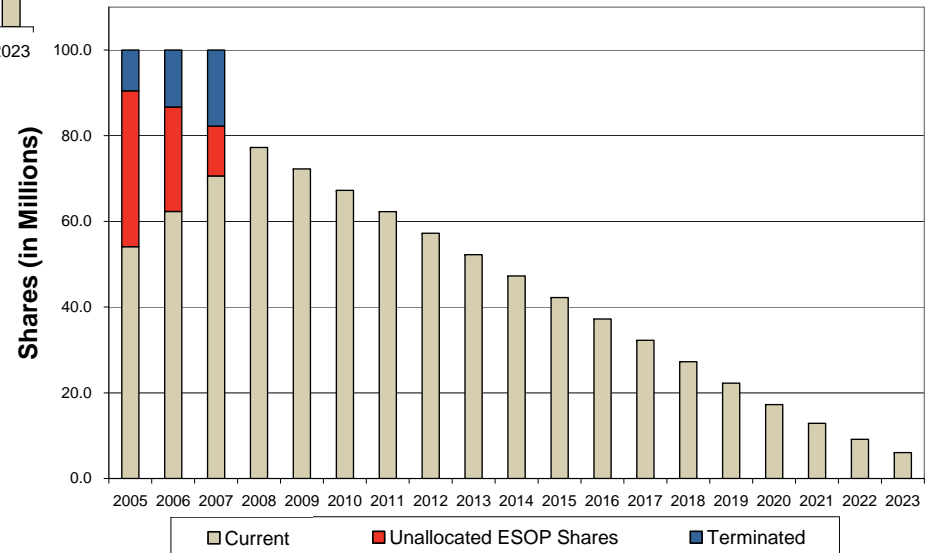


**Total Shares Projected to be Put By Employees, by Year**  
(Shares in millions)



- ESOP's loan from company is repaid in 2008
- Large number of shares put in 2008 reflect pent up demand as shares first become eligible to be repurchased
- Puts diminish as there are fewer shares outstanding, and no new share allocations

**Number of Shares and Ownership**



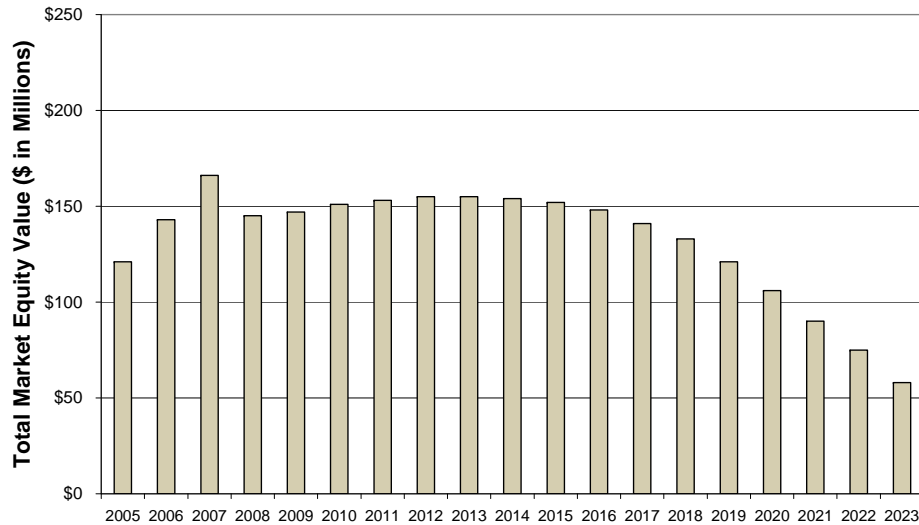
- Pent up put shares grow
- Unallocated balance declines until it disappears in 2008
- Allocated shares (all shares after 2008) decline steadily as put shares are redeemed



# Effect on Company Value of 100% Redemption

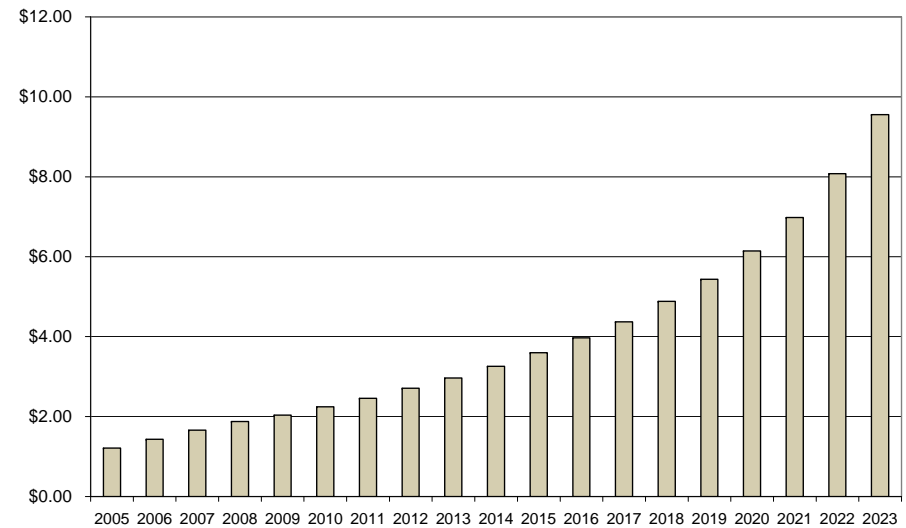


### Total Market Equity of Company (\$ in Millions)



- Total equity declines over time
- Company cash balances decline, and company must rely on debt to fund repurchases
- Company may not be able to fund ongoing investment in business

### Per Share Stock Price



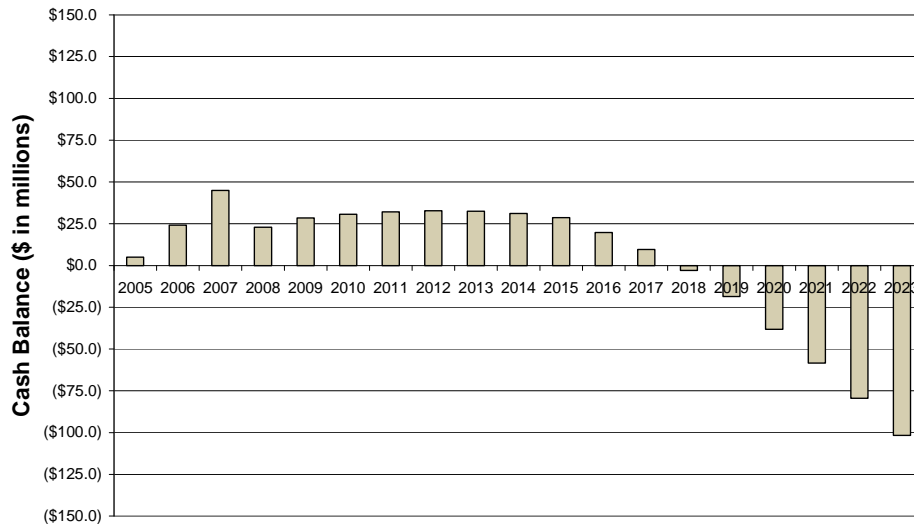
- Current participants (who terminate before liquidity runs out) fare very well
- Future participants do not participate in ESOP (“Haves” and “Have Nots”)
- Higher share prices increase future payouts



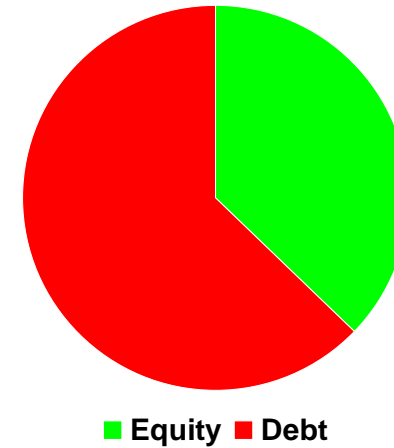
# Effect on Company Cash and Value in 100% Redemption



Company's Cash Balance  
(\$ in millions)



2023 Total Company Value



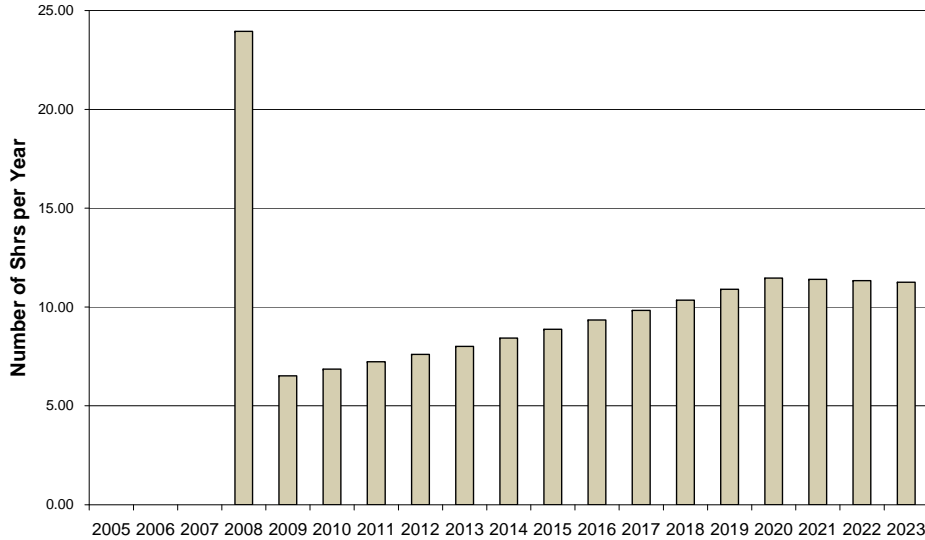
- Cost of put shares forces company to deplete cash and borrow
- Equity base declines substantially over time
- Situation in example is unsustainable over the long-term



# Example 2: 100% Recycling Share Puts and Number of Shares



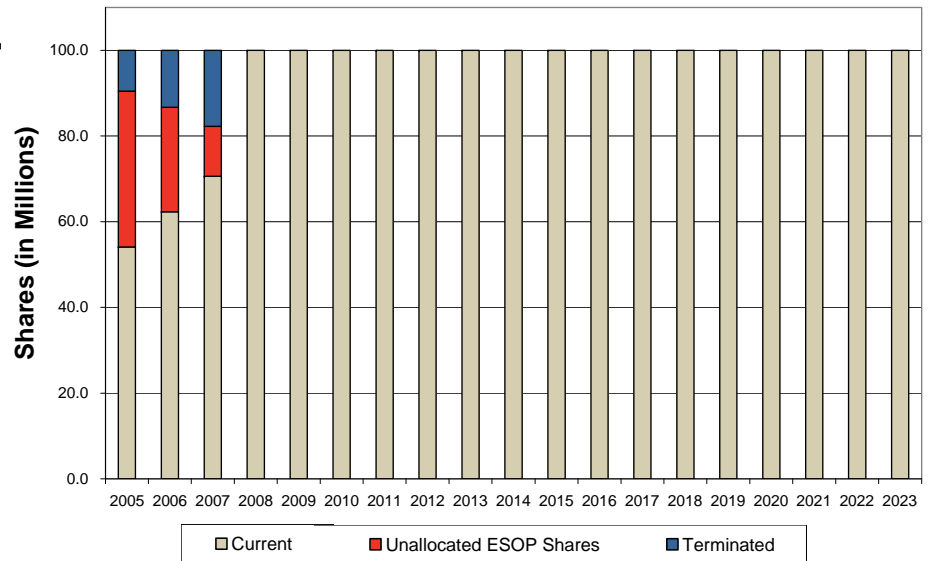
### Total Shares Projected to be Put By Employees, by Year (Shares in millions)



- Same pent up demand in 2008 as shares first become eligible to be repurchased
- More shares given to employees through recycling results in more shares put in each year
- Company purchases each share more than once

- Unallocated balance declines until it disappears in 2008
- Total share balance is constant
- Note difference from Redemption model, where share balance declines over time

### Number of Shares and Ownership

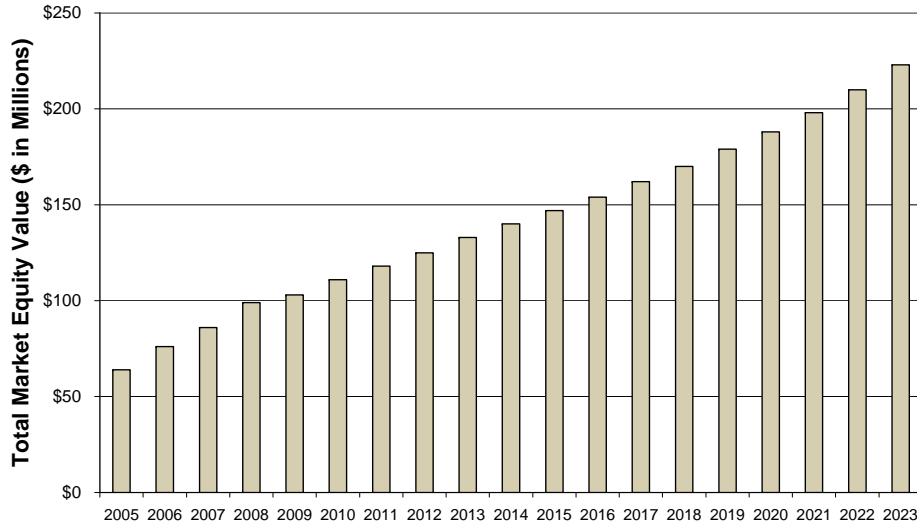




# Recycling Effect on Company Value



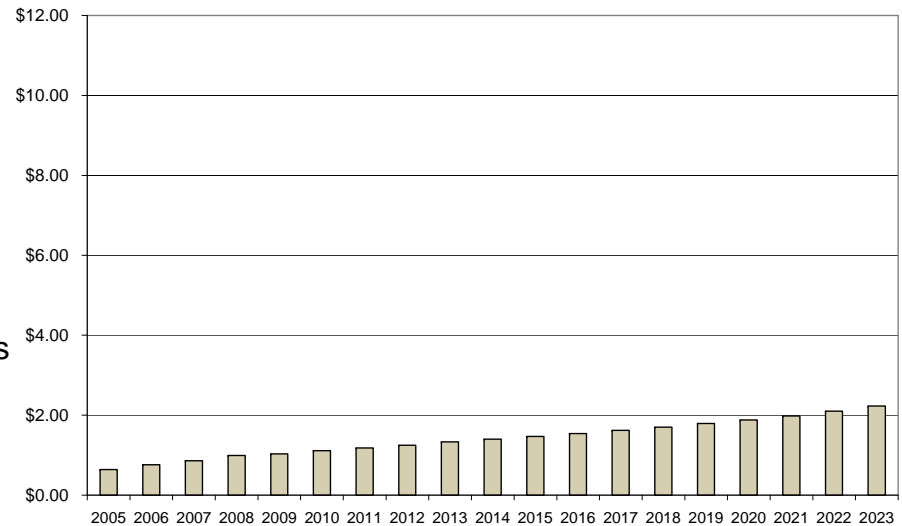
Total Market Equity of Company  
(\$ in Millions)



- Beginning total equity is substantially lower than in redemption scenario because it considers cost of recycling
- Total equity grows substantially over time (7% CAGR vs. -4% CAGR in redemption scenario)
- Company maintains ability to invest in appropriate projects

- Current participants may not do as well as in a pure redemption scenario
- Future participants do much better than in redemption case:
  - ESOP benefits are still available in future, and
  - Have about the same rate of account balance growth as current participants
- Each participant has many more shares (there are over 10x as many shares), but each share worth less per share

Per Share Stock Price

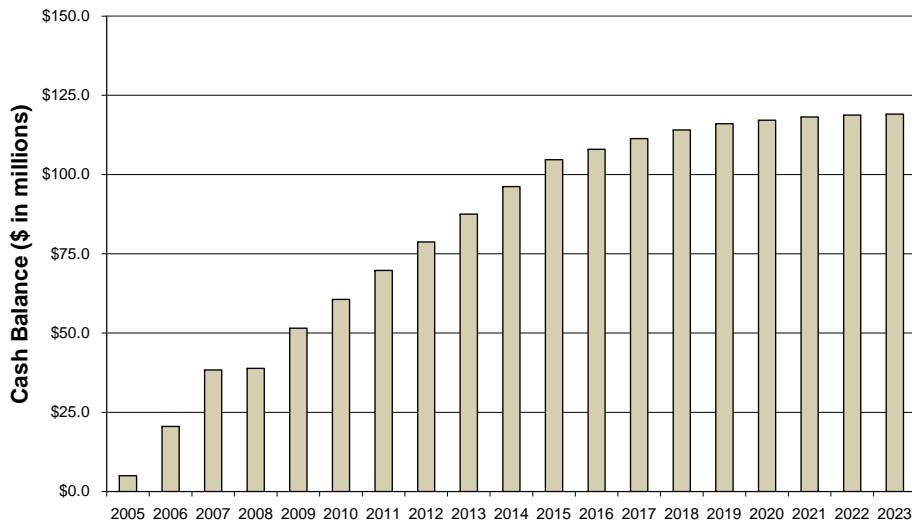




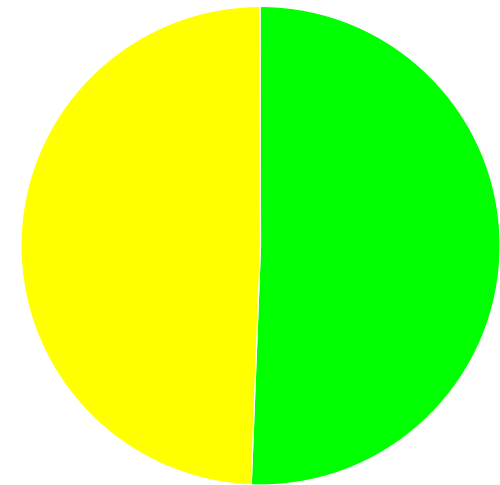
# Recycling Effect on Company Cash



### Company's Cash Balance (\$ in millions)



### 2023 Total Equity Value



■ Operating Value ■ Excess Working Capital

- Company has sufficient internally generated cash to pay in puts
- Cash balances have stabilized



## Important Take-Aways



Companies have significant control over their absolute repurchase liability

- Greater recycling lowers per share value (absent benefit substitution)
- More recycling redistributes shares and value among participants within ESOP
- More recycling may lower absolute amount of cash needed in a given year to repurchase ESOP shares
- How a company satisfies the ESOP put will affect a company's long-term cash needs and the ability to reinvest in its business

There is no absolute right answer as to whether a company should repurchase or recycle – conclusion depends on company goals

### Lessons Learned

- Repurchase obligations are not fixed
- Future repurchase obligations can change based upon decisions today
- Attention to decisions today will allow a company to make informed choices
- Company goals will drive the choices it makes regarding repurchase obligations