Managing an ESOP-Owned Company's Capital During Economic Instability

Chartwell Financial Advisory

Nearly every business has been affected in some fashion by the abrupt economic downturn, associated job losses, and capital markets volatility. ESOP-owned companies face even greater challenges given broad-based employee ownership requires the company to make an internal market for the company's equity. For ESOP-owned companies that also offer certain employees synthetic equity plans, these challenges can be further magnified as equity-based capital claims consume an increasingly higher proportion of free cash flow. Other privately owned companies can put equity decisions on hold during periods of economic instability; however, ERISA-based retirement plans allow (by law) plan participants to put their shares to the plan sponsor company.

Many Chartwell clients are seeking to gain an understanding of how prevailing economic and market conditions impact their valuation, repurchase obligation, access to credit, financial covenants, synthetic equity plans, and overall capital structure. What immediate actions can be taken to preserve cash and stabilize your company over the next several months? In this paper we will comment on a few key capital structure issues to help guide your thinking around cash flow planning, capital structure, and balance sheet management.

ESOP Equity Valuations

Irrespective of the current economic disruption on specific industries and public equity and debt markets, ESOP valuations conducted with an effective date of December 31, 2019 should follow a process consistent with historical ESOP valuations. In short, the valuation should be based on:

a. historical financial performance through the effective valuation date;

b. discussions with management regarding the company's historical performance (e.g., reasons for missing/exceeding budget);

c. changes in the company's market position (e.g., new products, competitor developments, etc.);

d. effective valuation date pricing of publicly traded companies and/or transactions; and

e. management's estimate of future financial performance.

Of significant importance regarding the above valuation process, the data and information utilized must be known or knowable as of the effective valuation date.

To be clear, record stock market levels in early February 2020 and the subsequent sharp stock market declines were not known or knowable on December 31, 2019. While this valuation timing is not in question, it will likely create a challenge in the execution of many December 31, 2019 valuations that have not yet been completed, or even initiated. Management teams (for valuations in process or yet to be conducted) will be asked to discuss the state of the company's business at December 31, 2019 and generate projections without being influenced by the prevailing economic conditions of Q1/Q2 2020.

Assuming an ESOP-owned company's value has been significantly impaired since December 31, 2019, an interim valuation may be considered. The ultimate decision on whether an interim valuation is prudent will likely depend on provisions in the ESOP plan document and analysis by the ESOP plan administrator or ESOP trustee. If an interim valuation is determined to be appropriate, the next challenge is determining the effective date. While the near-term economic impact may be apparent, the longer-term effects are likely much less clear. Delaying the interim valuation should provide more clarity on economic, industry, and business prospects and allow for a more directionally reasonable valuation.

ESOP Repurchase Obligation

Regardless of whether your company will be fortunate enough to operate through the current economic environment without requiring any reductions in force, the obligation to repurchase shares from diversifying and terminated participants remains. A reduction in force may certainly increase your near-term repurchase obligation; however, even funding your typical "year-to-year" obligations may put undue financial stress on your company. There are two key decisions that can help a company manage its repurchase obligation. The

first pertains to distribution timing. The second relates to how a company handles shares repurchased during the distribution process. Understanding the implications of these decisions may help reduce near-term repurchase obligation and keep the company (and the ESOP) on a sustainable path.

Modifying your current distribution practices could help minimize near-term repurchase obligations. Statutorily, distributions for reasons other than death, disability, and retirement must be paid in no more than five installments (larger balances can be paid over additional installments depending on the size of the balance), beginning no later than the sixth year following termination. Most practitioners agree that with proper ESOP plan document language or amendments, companies can switch from paying in a lump sum distribution to paying in installments. What is less clear is the ability to pivot from paying in the year after separation to utilizing the delay of up to five years. Check with your legal counsel on this issue.

Similarly, if you are currently segregating (reshuffling) participant accounts upon termination, you may have the discretion to not segregate during this time period, depending on the plan language. Finally, your ESOP plan may allow you to delay distributions related to shares allocated from the amortization of the internal ESOP note until it is paid in full. Any delay of distributions will help preserve critical cash for the business.

After you determine the timing of distributions, the next decision relates to how you will handle the repurchased shares. Recycling is when you use cash in the ESOP plan and/or contributions to the plan to repurchase the shares. The repurchased shares are immediately reallocated to remaining ESOP plan participants. Recycling is dilutive to per share value as cash leaves the company to fund the repurchase obligation, yet total shares outstanding remain constant. In contrast, in a redemption and retirement strategy, shares are distributed from the ESOP and repurchased and retired by the company, reducing cash and shares outstanding proportionally. A redemption strategy will increase per share value relative to a recycling strategy, which may be beneficial if economic factors are pressuring share price downward.

During these difficult economic times, cash is king and understanding your company's options when it comes to repurchase obligation will help you manage through the uncertainty.

Synthetic Equity

With the uncertainty around valuation in the market, companies are wondering if there is an opportunity to re-price share values and/or delay distributions under synthetic equity plans such as stock appreciation rights ("SARs") plans or other non-qualified deferred compensation plans ("non-qualified plans"). As always, it depends. There are two issues to consider: value and timing.

As to value, this is a matter of contract law and will turn on the language in the plan document for the non-qualified plans which can broadly be categorized into three main approaches:

1. If the non-qualified plan provides that fair market value ("FMV") equals FMV as determined for the ESOP on the last day of the preceding ESOP plan year, then the non-qualified plan value is fixed at the December 31, 2019 ESOP value and an interim valuation would not help.
2. If, however, the non-qualified plan has common language that ties FMV to the most recent ESOP value, the value for the non-qualified plan would automatically adjust to an interim ESOP valuation obtained prior to the plan distribution. If this is the case, it is important that the updated ESOP value is used for the non-qualified plan value. To do otherwise would likely mean the recipient was being paid at a value higher than FMV, in violation of the plan document and potentially creating issues under Section 409A (more below).
3. Finally, the non-qualified plan language might provide the board of directors with discretion to adjust the value or obtain an interim valuation.

This is a complicated area so be sure to consult with your legal counsel when interpreting these provisions.

Setting aside qualified plans (e.g., 401(k) plans, ESOPs), timing associated with Section 409A generally applies to all arrangements that defer the receipt of compensation for more than two and a half months after the end of

the year in which the compensation was no longer subject to forfeiture (i.e., vested). Section 409A applies to deferred cash compensation plans, phantom stock plans, and some SARs plans. If Section 409A applies, distribution timing must be objectively determinable on the date the award is granted and must be tied to permissible distribution events such as death, disability, separation from service, or a specific date (e.g., age 55). Once distribution timing is set at the time the award is granted, it cannot be altered or delayed to a later year unless making the distribution would create a financial hardship that would jeopardize the company's ability to continue as a going concern.

Note that the distribution cannot be delayed merely because the distribution would cause the company to violate a loan covenant. Further financial analysis is needed to determine whether violating the loan covenant would cause going concern status to be threatened. If making the distribution would jeopardize going concern potential, the distribution can be delayed until the first taxable year that making the distribution would not risk going concern potential. Also note that even if the distribution can be delayed due to going concern considerations, the value paid in the subsequent year might still be the December 31, 2019 value based on the contractual arrangement, as discussed earlier.

Some arrangements are not subject to Section 409A—for example, SARs or stock options where recipients can choose when to exercise the award, the awards are granted at fair market value (i.e., non-discounted), and payment occurs at the same time the award is exercised. Recipients holding such 409A-exempt SARs and stock options might prefer to exercise now to avail the December 31, 2019 price. Or, if it is clear the non-qualified plan value would follow an interim valuation as discussed above, such recipients might decide to delay the exercise—as provided by the exercise window afforded by the plan document—until the stock price has recovered to their liking.

Finally, for participants covered by a non-qualified plan subject to Section 409A who might need extra cash (e.g., layoffs or significant medical expenses), Section 409A allows both a cessation of elective deferrals to a non-qualified plan and a distribution of benefits from a non-qualified plan due to "an unforeseeable emergency" and "other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider." The provision goes on to set a very high bar for such distributions however, even contemplating the liquidation of other resources to cover the emergency.

As always, discuss with your legal counsel regarding the applicability of Section 409A and the specific provisions of your plan.

Capital Markets

The negative effects of COVID-19 have had a swift and severe impact on the credit and equity markets in recent weeks. At the risk of sensationalizing the situation, the broadly syndicated leveraged loan market experienced shockwaves that are still being analyzed. Primary new issuances were effectively put on hold and the secondary market experienced significant discounting as participants tried to price the risk of economic instability on the U.S. (and global) economy.

The middle market and private debt market felt a similar impact. While lenders took a pause on extending new credit, banks and non-bank lenders began to look inward at their own portfolios to assess liquidity issues and other potential near/intermediate term concerns. Meanwhile, companies began to draw down on their revolvers to maintain liquidity as government mandated restrictions and other containment efforts significantly curtailed business activity. Even in situations where liquidity was not tight, companies drew down significant amounts from their revolvers due to the uncertainty of near-term liquidity and how long government restrictions might persist. Based on market data as of March 26, approximately $140 billion of revolver draws occurred since March 5 (Source: LCD).

Though the events of the last few weeks were difficult to experience, lenders and other capital providers are open for business. While the 2008 housing crisis created liquidity constraints for the financial markets, the current economic disruption is hitting Main Street and companies first. There is plenty of liquidity and capital held by financial institutions. The struggle for lenders and debt investors in today's environment is understanding how to properly price the risk (i.e., the spread over the base rate). Until the bottom of this crisis

is identified, it will be difficult for lenders to understand their true risk exposure.

We continue to see lenders and capital providers seeking new opportunities; however, these opportunities will involve companies with a higher credit quality and a very clear understanding of the impact of the recent market disruption on operations, or, simply put, highly valued and liquid collateral. In addition, higher pricing and tighter terms (e.g., financial covenants, lower leverage, etc.) can be expected. We are seeing lenders more focused on asset value and asset coverage in loans and moving away from traditional cash flow-based loans, at least for the time being. As volatility subsides and downside risks are better understood, more capital will free up for issuers in due course albeit under "new-normal" pricing, terms, and conditions.

Many companies, including Chartwell clients, are not looking for new capital but rather attempting to manage their current capital structure. With pressure on revenue and operating cash flow, many companies will be experiencing near-term covenant violations.

In these instances, we are seeing some credit providers allow for a postponement of current principal and interest payments on current facilities and adding this amount to the backend of the facility (i.e., extending the maturity of the facility). In addition, depending on the severity of the covenant violation, waivers can also be obtained. Lenders are interested in understanding the full impact from COVID-19 and asking for clarity on near-term liquidity needs (e.g., 13-week cash analyses) and updates to financial forecasts/projections. Unfortunately, the ramifications of the ongoing disruption are still not known for most companies. However, companies can quantify cost reduction initiatives, personnel cost savings, and severance amounts, among others, and request EBITDA addbacks for covenant calculation purposes. In addition, we encourage companies to propose COVID-19 lost revenue as potential addbacks, which will likely be part of the credit conversation upon market normalization.

Managing financial covenants is one thing; managing actual cash flows such as operating expenses, ESOP distribution payments, and capital expenditures are another matter. Some of these payments may become restricted while in violation of a financial covenant. We encourage discussions sooner rather than later with your lenders. Ideally, seeking guidance and advice from your advisors and other professionals should occur prior to these discussions. Before making decisions that impact capital allocations, it is important to assess your overall capital structure and near/intermediate term obligations.

Determining your goals and objectives will help you understand the proper next step. Is it simply to make payroll? Perhaps an upcoming repurchase obligation payment is due? The answers to these questions will determine if a simple waiver is needed from your lender or if an extensive renegotiation of your capital structure is required.

Summary

These critical considerations are interconnected. In a perfect world, a current assessment of the health of your business would correlate—and connect—each consideration in the context of your company, industry, and market conditions. While this is difficult during normal times, it becomes increasingly complex—yet even more important –during times of uncertainty and instability.

Chartwell professionals are actively supporting and advising leaders of ESOP-owned companies on these complex topics. The breadth of experience across our team allows Chartwell to provide a holistic review of your current situation and offer unbiased advice with respect to optimally managing your capital structure.

A seasoned assessment of your company's situation will help you see more clearly. Making the next right decision is your challenge. Helping you do so is our mission. ■

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