ESOP repurchase obligation funding

Protect your business and ESOP benefits.

Presented to:

Sample company

Presented by:

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Proprietary and confidential

We appreciate the opportunity to prepare and present this ESOP repurchase obligation funding proposal.

The information contained in this proposal has been developed based on our years of knowledge and experience in working with business owners and employers. Rest assured that the information contained in this proposal will be kept strictly confidential.

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Proactive planning can be the key to your success.

Your company has implemented an employee stock ownership plan (ESOP). The last thing you want to see is the effectiveness of that ESOP become derailed by unplanned—or even planned—events. There are long-term planning strategies you can put in place to help protect your business and your employees.

With an ESOP, the company is required to repurchase the shares of departing or retiring employees who are vested participants in the plan. So, implementing an ESOP repurchase obligation funding strategy is one of the most efficient ways to help protect your business from both planned and unplanned exit events.

A funding strategy can help you:

- Reduce the risk that the cash required to repurchase shares will compete with cash needed for effectively running the business and investing in other opportunities.
- Avoid a negative impact to your company's financial decision making because of employee departures.
- Enable your company to achieve and maintain a more levelized cost for meeting this obligation.

WHAT TO EXPECT

Let's walk through the flexibility of this plan and how it can be tailored to fit your specific needs. You're in control of key decisions and determining next steps. So, this proposal will help you do that by covering the following areas:

Design. Look at the various obligation funding methods and choose the design that can help you accomplish your goals.

Financing. Decide which option best balances long- and short-term costs and benefits.

Support. Understand the valuable support services available to maintain this funding strategy.

Next steps. Review how to implement your strategy.

Before we dive into the details of designing your strategy, let's take a quick look at the ESOP repurchase obligation and forecasting your liability.

What is an ESOP repurchase obligation?

This is the liability a company incurs when vested participants are entitled to receive distributions from an ESOP. While publicly traded companies are market-traded, closely held companies must provide the funding necessary to repurchase shares from ESOP participants owed a distribution. This is an off-balance sheet liability that's not required to be booked on the company's financial statements, but it's generally in the best interest of the company to prepare for this impending liability.

These events will require the ESOP to repurchase participants' vested ESOP shares with cash:

- Retirement
- Death
- Disability
- Option to diversify[1]
- Terminations (voluntary and involuntary)

Other repurchase obligation events could include participant loans, hardship withdrawals, qualified domestic relations order (QDRO) payouts, and early diversification. Refer to your specific ESOP plan document to see if other events apply.

How much is your liability?

Companies often perform a repurchase obligation study to estimate their long-term liability. This forecasting study is a projection of the distributions required when employees retire, die, become disabled, diversify, or terminate employment.

Factors that may impact the calculation include:

- Participant demographics
- Participant balances
- Years of service
- ESOP loans
- Distribution policy

If you have provided us with a copy of your latest repurchase obligation study, it's included at the end of this proposal.

[1] Employees who have reached age 55 and have at least 10 years of participation must be permitted to begin diversifying their accounts. See IRC Sec. 401(a)(28).

Designing a strategy to fit your needs

You're in control of making an ESOP repurchase obligation funding strategy your own. Our role, in partnership with your financial professional, is to help you consider the alternatives that might make sense for your specific organization.

STRATEGY ALTERNATIVES	BENEFITS AND CONSIDERATIONS
No funding Pay as you go from working capital or earnings.	• Simple • Future cash flow could be insufficient.
Debt Tap unused debt capacity, including lines of credit, term loans, or pay participants with a note.	• Costs spread out over time. • Interest charges increase costs. • Availability of credit is uncertain.
Assets owned by the ESOP Accumulate assets inside the ESOP through employer cash contributions, dividends, and S corporation distributions.	• ESOP trust assets are not accessible by company creditors. • Assets are permanently removed from company balance sheet and may not be used for other business purposes. • Assets are allocated to plan participants and paid out as the participants leave.
Assets owned by the company Accumulate assets in a sinking fund on the company's balance sheet.	• Assets are available for any business purpose. • Assets not protected from company creditors.

Many businesses can achieve positive returns by investing in their own business. However, ESOP companies have an additional obligation—to create the necessary liquidity to meet future repurchase requirements. Business operating assets, like equipment and buildings, are generally not liquid, and future cash flows can be unpredictable and insufficient at the exact time cash is needed. Therefore, developing a funding strategy may be important, not only to the ESOP, but to the financial well-being of your business.

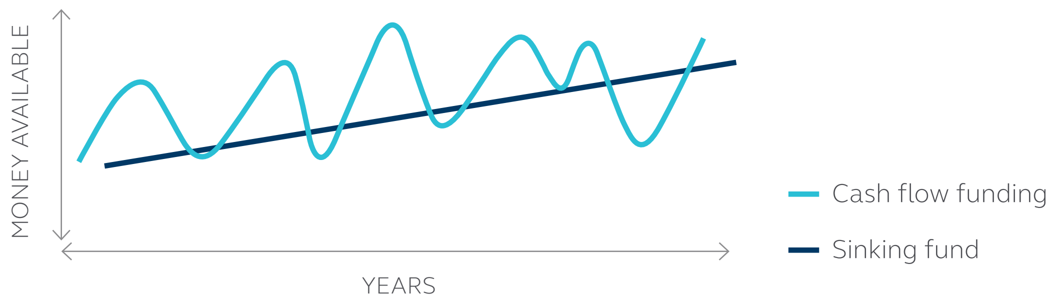
A sinking fund can proactively address your liability

Let's take a closer look at setting aside dollars today to help meet cash needs in the future. There's value in creating a reserve in the event the repurchase obligation costs for a given year exceed cash availability. The timing of employee retirements, terminations, deaths, and disabilities is unpredictable — and so is the amount of cash needed for ESOP repurchase obligations. A sinking fund can help.

How does a sinking fund work?

You systematically set aside money over time to fund a future expense, in this case, repurchasing ESOP shares.

The sinking fund provides a pool of money for making distributions when there are repurchase obligations. Since cash flow can vary from month to month, a sinking fund may help the company "smooth out" its cash commitments to the ESOP repurchase obligation each year.



Sinking fund **benefits**

- Reduces and levelizes the cash flow required to repurchase shares in future years
- May be viewed positively by ESOP participants and trustee
- Used to finance the repurchase obligation and remains on the company's balance sheet
- Available for any corporate purpose

Sinking fund **considerations**

- Unprotected from creditor claims
- May be insufficient, and the company is ultimately responsible for fulfilling ESOP repurchase obligations

How much reserve should you establish?

The decision about how much to fund is a risk-management decision. Some companies maintain a reserve equal to approximately three to five years of the future projected ESOP liability. Other companies elect to prefund more. It's important to start building the sinking fund early, so assets have time to accumulate.

Considerations

- Is the intent of the company to increase, decrease, or stabilize ESOP ownership?
- What is the desired size of the reserve to be established?
- How much has the company set aside to date?
- What is the availability of cash on an annual basis?
- What other benefit plans does the company offer key employees?
- Does the company have commitments to other non-ESOP shareholders?
- How much cash flow is required to fund other current liabilities versus future ESOP liabilities?

Consider your answers to these questions as you review the **attached financial model** that summarizes funding strategy options for your company based on the information you have provided.

Funding your obligation

Being able to pay benefits to ESOP participants in the future is required. Any one of these three options (or a combination of some or all) can help you meet these funding obligations.

Unfunded. No specific assets are set aside to fund repurchases. Instead, benefits are paid from the company's cash flow.

Investments. Company contributions are invested in vehicles, such as stocks, bonds, CDs, or mutual funds.

Corporate-owned life insurance (COLI). The company purchases cash-value life insurance to pay future obligations. The company is the owner and beneficiary of the policies. Contributions are paid into life insurance policies—either fixed, indexed, or variable.

	UNFUNDED	INVESTMENTS	COLI
Benefits	• Simple • No asset to manage.	• Direct crediting of earnings • Flexible contributions • No medical underwriting. • Investments reported on the corporate balance sheet. • Investments available for any company purpose.	• Earnings accumulate tax-deferred. • Flexible contributions • Key person insurance and cash values are available for any company purpose. • Cash surrender values are an asset on the corporate balance sheet. • Life insurance policies may selectively cover those ESOP participants with large account balances. • Income tax-free death benefit may provide cost recovery.
Considerations	• No future assets set aside to pay benefits. • Liquidity risk • Repurchase requirements can be volatile. • Cash may not be available, potentially requiring debt and other financing.	• Earnings may be taxable. • Investment fees and expenses • No death benefit.	• Must qualify for insurance and meet underwriting guidelines • Cost of insurance, policy fees, and expenses • Insured employees must sign a Notice and Consent form (IRC Section 101(j)).

To help you better weigh your options, we've provided a detailed financial model at the end of this proposal.

Investing in mutual funds, variable annuities or variable life insurance involves risk, including the potential for loss of principal. Guarantees are based on the claims-paying ability of the issuing insurance organization.

Focused on your strategy's details—today and tomorrow

It takes a lot of work to run your business. We understand that you may not have time to think about the details associated with administering your ESOP repurchase obligation funding strategy. That's why we're here. We offer the expertise and service to help you with implementation and administration.

Expertise

When implementing this strategy, it's helpful to work with a provider that has the expertise and experience to understand how to turn your objectives into a successful strategy. Our team of business solutions experts will consult with you and your financial professional to determine the right solution for your organization.

Service

We know you need to spend your time focusing on your business. That's why we focus on the details, so you don't have to. Our plan administrative services professionals assist you with the day-to-day aspects of your strategy.

Walking you through a successful implementation

Helping you tailor an effective ESOP repurchase obligation funding strategy to help meet your specific needs and goals is a top priority. Once you're comfortable with the design of your strategy and the supporting funding, attention will shift to putting the strategy in place using the Principal platform.

As everyone works together to successfully implement your funding strategy, our goal is to deliver a positive experience. Here's what you can expect:

Next steps

1 Strategy development

- Finalize design
- Confirm funding levels

2 Application process

- Educate participants on the funding program
- Collect applications and signatures, if applicable

3 Administrative set-up

- Finalize underwriting, if applicable
- Enter plan information into recordkeeping systems

4 Implementation

- Transfer funds
- Issue new insurance policies, if applicable

An industry leader in your corner

Everything you need in one place

Once you decide what is right for you, we'll bring our expertise and resources to the table to help you execute your strategy. Everything you need to successfully implement and maintain it is available at Principal:

- Innovative plan design
- Multiple funding options
- Efficient plan implementation
- Dedicated plan administrative services

You can trust our expertise and leadership

We've been providing administrative services for business solutions for more than 30 years, making it a priority to understand where you want to be and how you plan to get there. This means you'll get expertise and innovative ideas when you need them to make your financial progress possible.

A member of the FORTUNE 500®, we have $714 billion in total assets under management[1] and serve clients worldwide of all income and portfolio sizes.

- Serve 1,100+ ESOP[2]
- No. 1 ESOP recordkeeper by number of plans[2]
- ESOP clients in all 50 states, plus Washington D.C.[3]
- Provide services to 40 of the nation's Top 100 largest majority employee-owned companies[4]

[1] 2022 Company Profile. Data for the trailing 12 months ended December 31, 2021.
[2] PLANSPONSOR Recordkeeping Survey, July 2021.
[3] As of June 30, 2021, including ESOPs and KSOPs.
[4] According to The Employee Ownership 100 published by the National Center for Employee Ownership (NCEO), October 2021.

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