Principal®

Overview | ESOP repurchase obligation funding

Help protect your business and ESOP benefits.

Proactive planning is key.

The last thing you want is to see the effectiveness of your employee stock ownership plan (ESOP) be derailed by planned—or unplanned—events. Are you fully prepared to repurchase shares of departing or retiring employees who are vested participants in your plan? Implementing an ESOP repurchase obligation funding strategy is an efficient way to help protect your business.

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.

Strategy alternatives

There are four main options to consider as you shape a strategy that best meets the needs of your organization:

No funding. Pay as you go from working capital and earnings.

Debt. Tap unused debt capacity, including lines of credit, term loans, or pay participants with a note.

Assets owned by the ESOP. Accumulate assets inside the ESOP through employer cash contributions, dividends, and S corporation distributions.

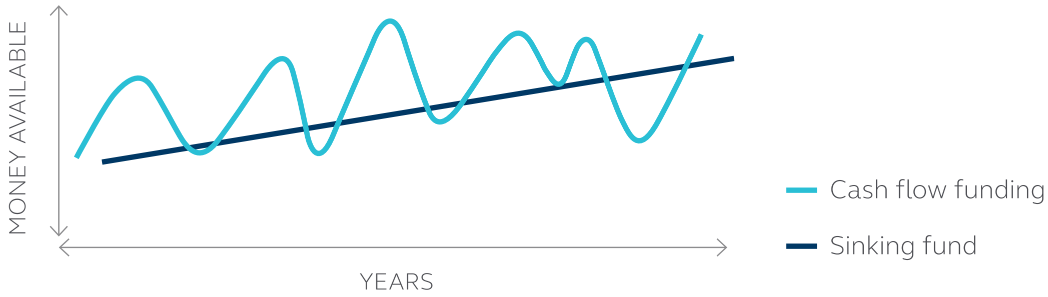
Assets owned by the company (sinking fund). Accumulate corporate-owned assets, which are included on the company's balance sheet.

ESOP companies have an obligation to create 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. So, many find that setting aside dollars today in a sinking fund is best for their company. It allows them to create a reserve in the event 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.

Here’s how a sinking fund can help.

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

The sinking fund can include a variety of investment vehicles, including stocks, bonds, CDs, mutual funds, and corporate-owned life insurance (COLI). All of which can provide 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.



Benefits

Minimized cash flow reductions. Reduces and levelizes the cash flow required to repurchase shares in future years

Considered a company asset. Used to finance the repurchase obligation and remains on the company’s balance sheet

Flexibility. Available for any corporate purpose

Things to consider

Lack of creditor protection. Considered a company asset and unprotected from creditor claims

May not meet all funding needs. If the sinking fund is underfunded, it may be insufficient, and the company is ultimately responsible for fulfilling ESOP repurchase obligations

Having a strategy for funding repurchase obligations makes sense for protecting your business and your ESOP benefits. When you’re ready, we can also help you determine what your repurchase obligation might be and discuss an appropriate funding strategy. Then, we’ll work with you and your financial professional to successfully implement the strategy that’s right for you.

Learn more | Contact your financial professional today.

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