

# Demystifying ESOPs as an Exit Planning Tool

## XPX - Boston

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October 27, 2011

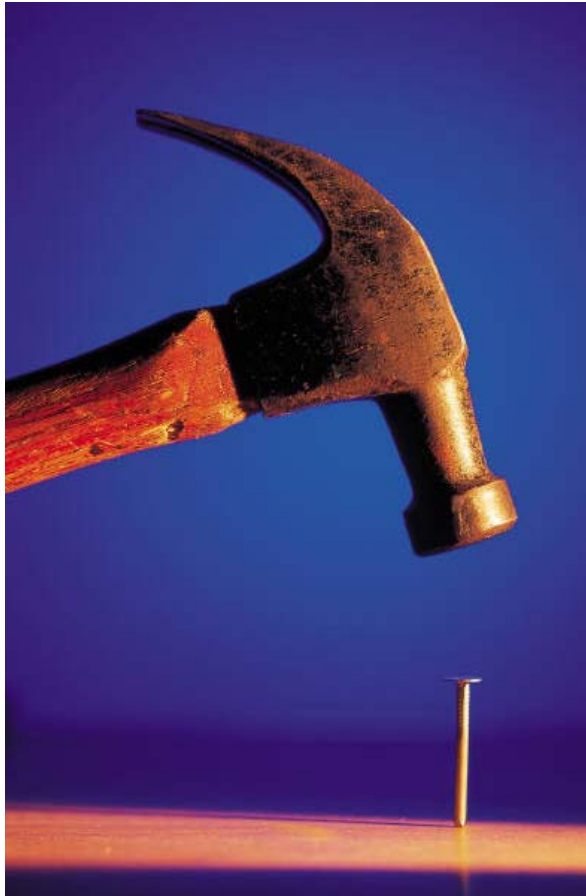
**ESOP**

**JEOPARDY!**

# There are Several Exit Planning Tools



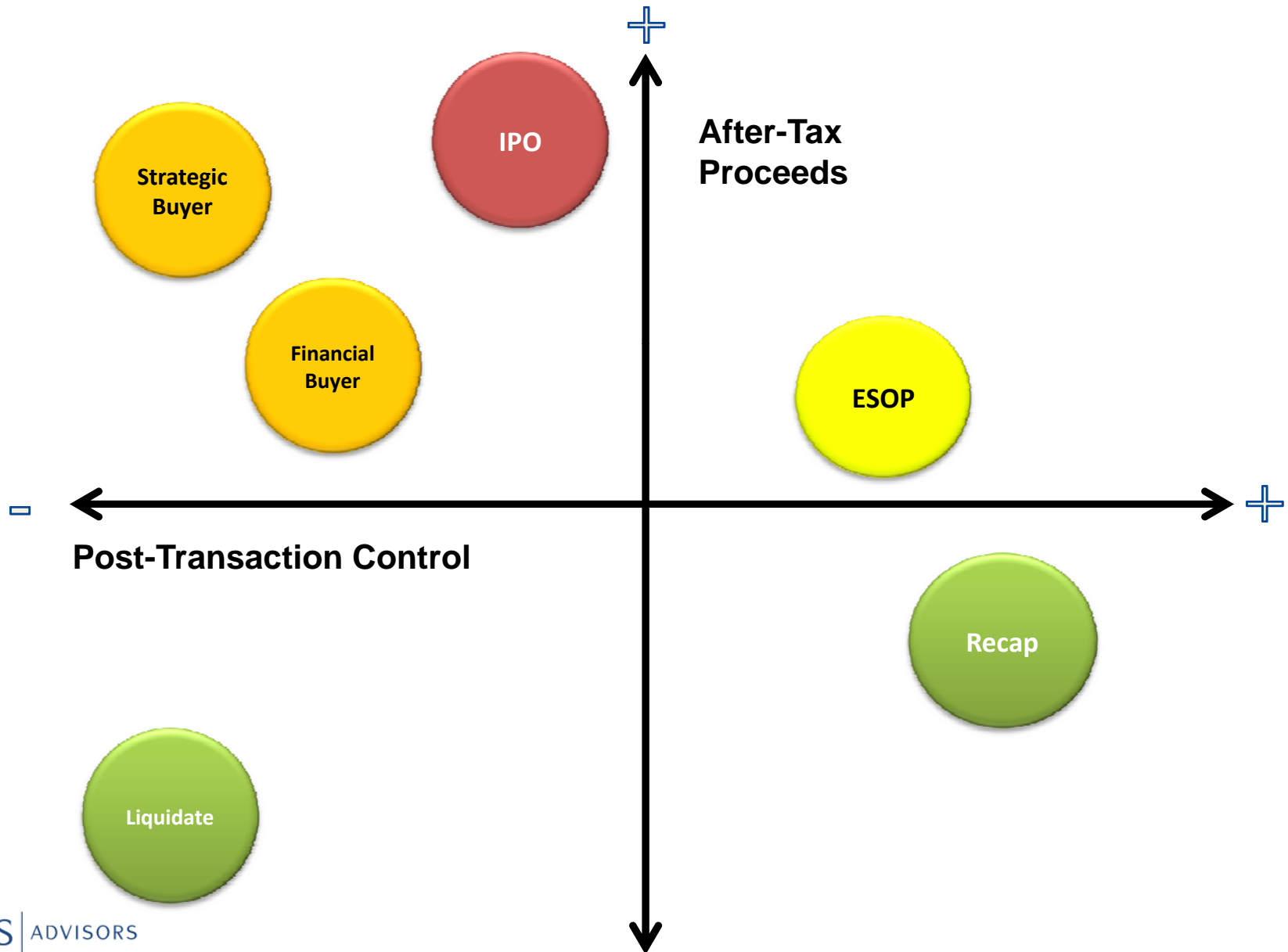
# The 3<sup>rd</sup> Party Sale is the “Hammer” of Exit Strategies



# The ESOP is the Welding Machine of Exit Planning



# Most Common Exit Planning Vehicles



# Exit Planning Constraints

- The ownership transition issues typically facing private business owners:
  - What % of company to sell...All or part?
  - What price to sell at...Maximum or reasonable?
  - Liquidity....Immediate cash required or can the owner accept an “extended payment plan”?
  - Timing....Immediate or over several years?
  - Control...Who will own/run the company in the future?
  - Legacy....Is it important to perpetuate the company’s mission and legacy?
  - Management...Is it important for management to have a shot at controlling their destiny?
  - Transaction taxation...Taxable or tax deferred?
  - Multiple shareholders’ objectives...Similar or dissimilar?

# The “Dark Side” of ESOPs

- Department of Labor fiduciary risk with respect to valuation and other matters
- Internal Revenue Service oversight as a qualified retirement plan
- Anti-dilution protection under 409(p)
- Company’s repurchase obligation of distributed ESOP shares
- Sale of company when an ESOP is a shareholder
- Complexity/lack of understanding

# The ESOP is Probably Not the Best Choice When....

- The selling shareholder wants to sell all of the company at the absolutely highest price for as much (all?) cash as possible
- Company equity value is less than \$2 million
- There aren't enough "E's" for the ESOP
- The company has volatile/inconsistent earnings and debt is needed to finance the transaction
- The company's business model and/or forecasted performance is unsustainable
- Company is NOT an S or C corporation (e.g. LLC) and there is pre-transaction debt outstanding
- The owner-operator wants an immediate and full exit and the company lacks a viable management succession plan

# Other ESOP Issues to Consider

- Balance sheet impact of leveraged ESOP transactions
- Bank financial covenants
- Franchise/manufacturer approvals for distributors, dealerships, etc.
- Bonding/surety issues for contractors
- Professional corporation ownership restrictions

# ESOP 101

# What is an ESOP?

- “Employee Stock Ownership Plan”
- Company funded employee benefit - no employee contributions
- Employees do NOT own the stock
- Qualified retirement plan under IRS
- Only qualified retirement plan that can borrow money from an insider
- No corporate financial disclosure required except in limited circumstances

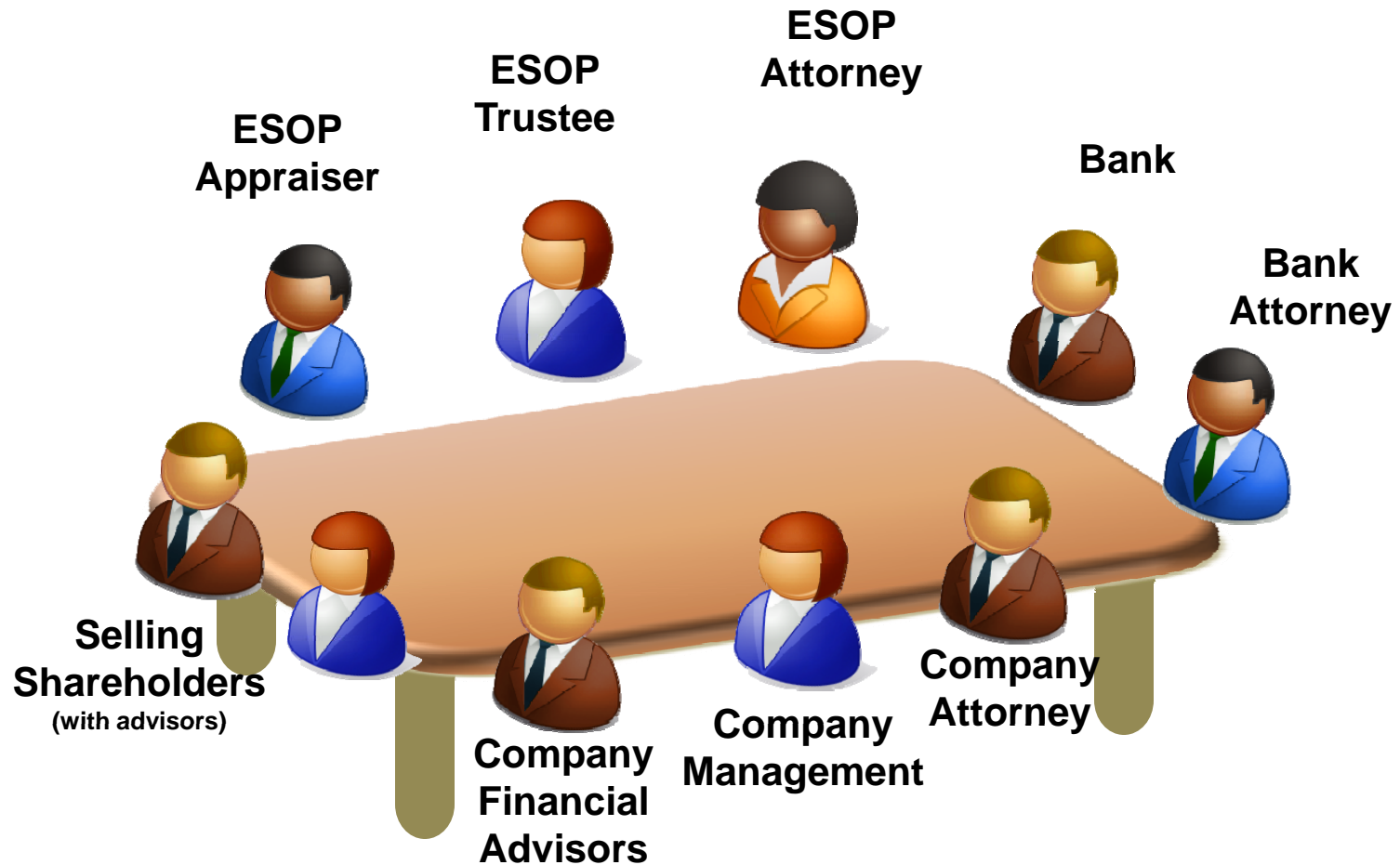
# Beauty is in the Eye of the Beholder...

- **To the Shareholders the ESOP is:**  
*...a Flexible, Tax Efficient Buyer of Stock*
- **To Employees the ESOP is:**  
*...a Company Funded Retirement Plan*
- **To Companies the ESOP is:**  
*...a Corporate Finance Technique*

# Why Use An ESOP:

- To make a market for an owner's stock in a tax efficient and controlled manner
- To defer payment of capital gains taxes resulting from a stock sale
- To finance a stock buyout using pre-tax interest AND principal payments
- To create a business that is essentially free from all federal and most state income taxation
- To enable owners to sell shares while maintaining control of the company and perpetuating the company legacy
- To motivate, retain and reward employees

# Constituents in an ESOP Transaction



# Appraisal Considerations & Issues

- Privately-held companies must have their stock price determined by an independent, third-party appraiser who works for the trustee
- Appraisals for stock transactions will be as of the transaction date and at least annually at year end
- Company stock also has to be valued annually for purposes of valuing the retirement benefit
- Several valuation methodologies are traditionally used
  - Income
  - Comparable
- Historical as well as normalized and projected earnings considered
- Analysis of prior transactions or offers can be used, under certain circumstances
- “Lack of Marketability” discount is in the 5-10% range
- Control premium when ESOP gets true control

# Role of Trustee

- At time of transaction
  - Trustee is the effective buyer of stock, and must make a fiduciary decision that the stock purchase is being made for the “exclusive benefit” of the ESOP plan participants
- Ongoing
  - Trustee votes for board of directors
  - Oversees proper plan stewardship of plan assets
  - Negotiates future stock sales or purchases

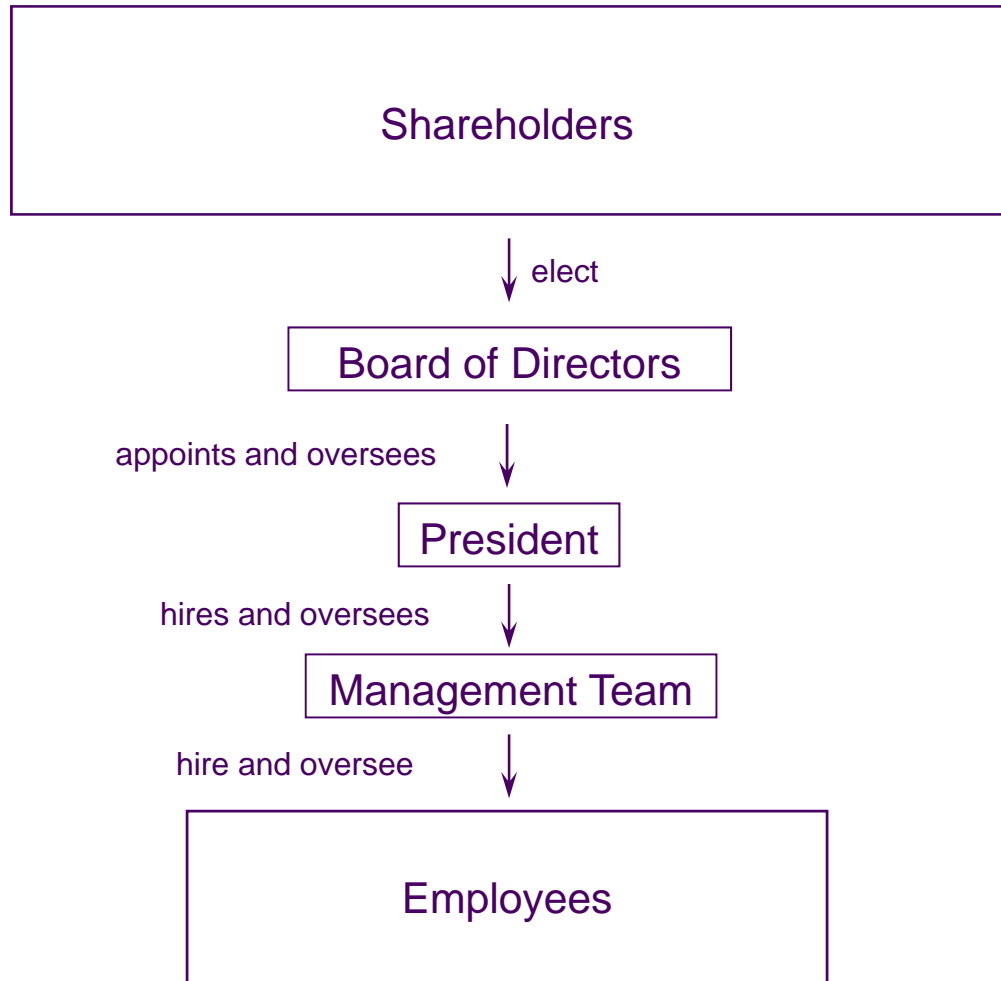
# Required Annual Information Disclosed to Employees

	<u>Yes</u>	<u>No</u>
• ESOP Account Balance	✓	
• Vested Percentage	✓	
• Per Share Value of Stock	✓	
• Financial Statements		✓
• Salaries of Officers		✓
• Valuation of Company		✓

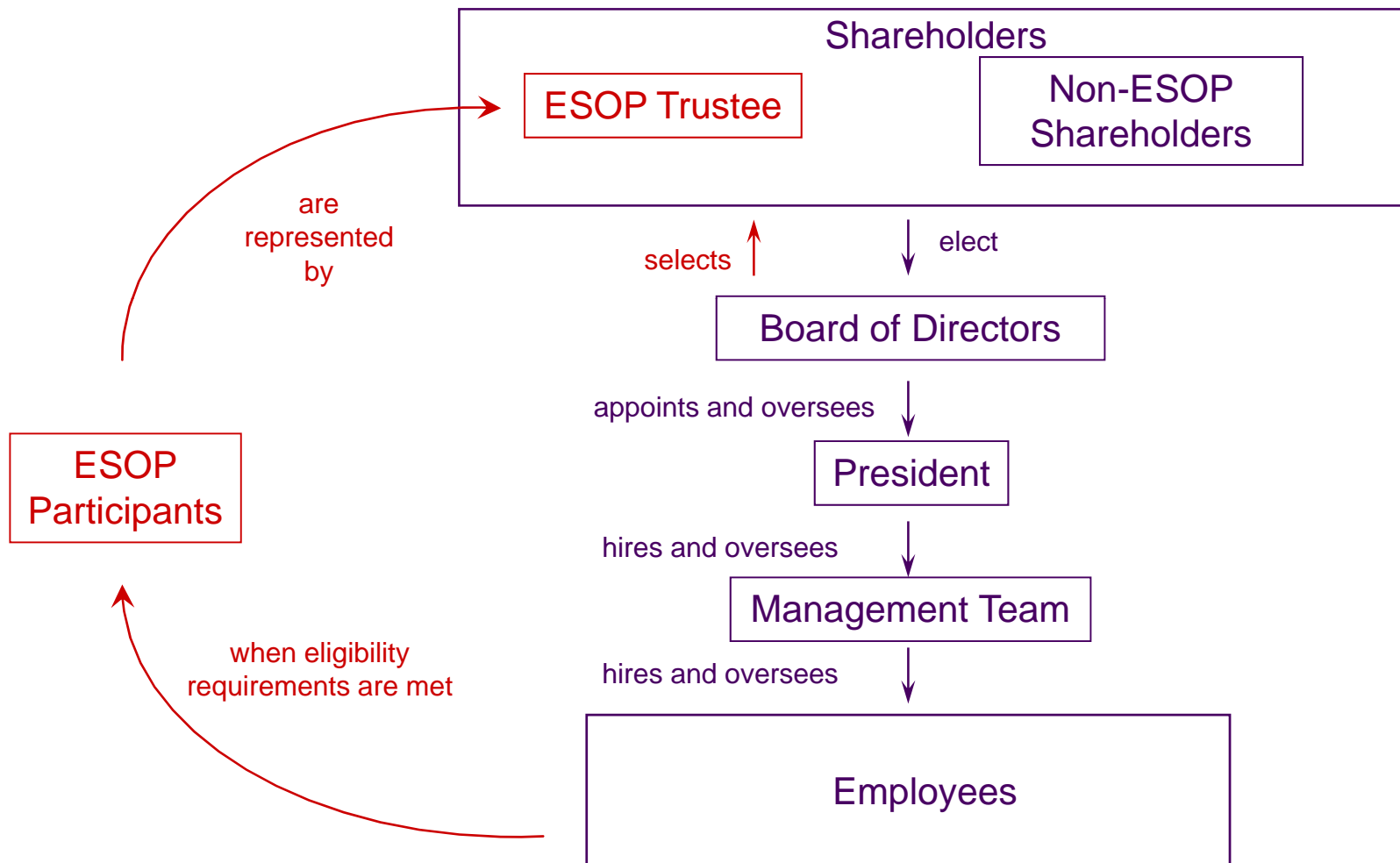
# Stock Voting Rights

- On ordinary issues – Trustee votes stock unless company wants to provide employees with vote
- On special issues – “Pass-through” voting rights:
  - On merger, consolidation re-capitalization or on liquidation or sale of substantially all corporate assets
  - ESOP Participants only vote allocated shares
    - Trustee votes the unallocated shares
  - No pass-through voting rights for sale of stock for cash

# Company Structure Before ESOP



# Company Structure After ESOP



# Case Studies

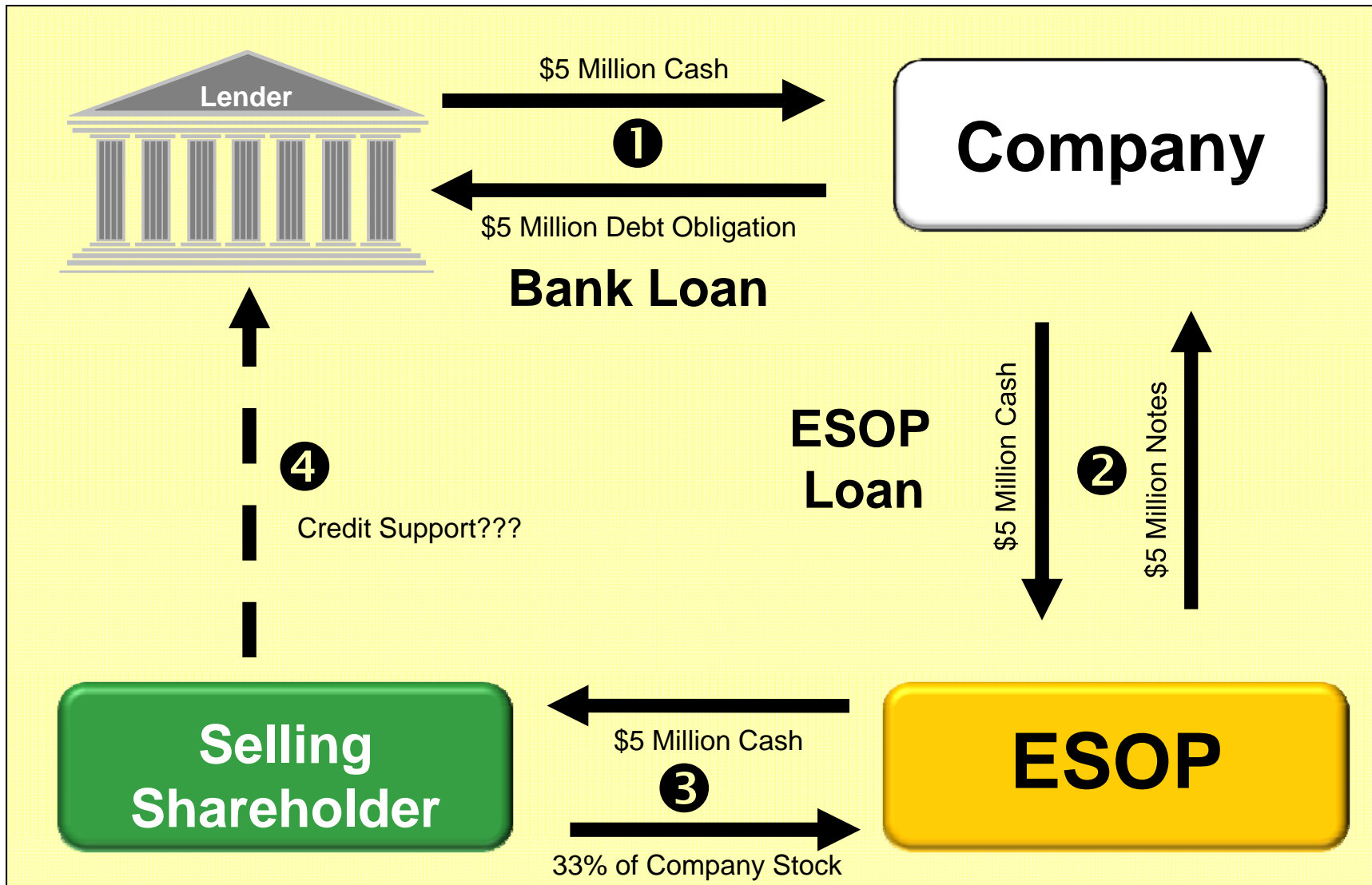
# Case I

- Profitable C corporation engineering firm with 50 employees
- Currently four shareholders with ages ranging from 45-63
- Stated Objectives
  - Founding shareholder is 63 and is seeking to liquidate his 35% block
    - Founder is looking to “throttle back” over the next 4-6 years
    - Younger shareholders are in for the long-haul
    - Founder is willing to seller finance transaction or provide “pledged proceeds”
  - Company realizes that it has to cash out founder (a buy-sell exists), but it wants to preserve capital for growth
  - Company recognizes that the employees are its “assets” and they are seeking a broad-based equity plan

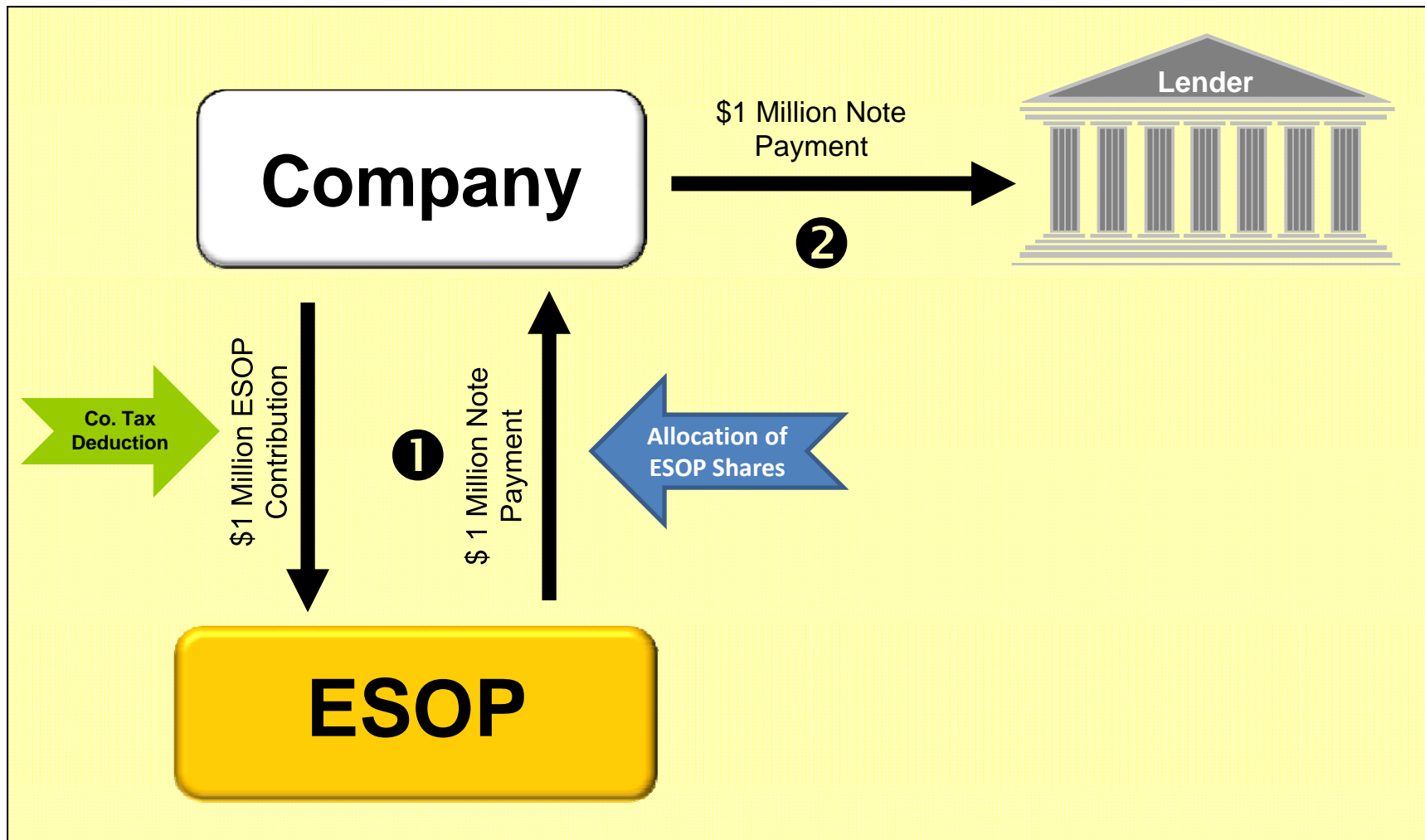
# Case I Solution

- **Minority Interest Leveraged ESOP**
  - Selling shareholder has the option of deferring capital gains on the transaction
  - Due to lack of “bankable” collateral, selling shareholder will pledge invested transaction proceeds as collateral on the bank loan
  - Employees will receive ESOP shares over five years and in proportion to their income
  - Company has created a market for future stock liquidations from shareholders
  - Minority discount is mostly offset by the value benefits of a convertible preferred stock
  - Retirement benefit is providing “double-duty” for the company
  - Company will borrow \$5 million to finance the transaction and will effectively be able to write off both the interest and the principal on the loan

# Leveraged ESOP Transaction



# Paying Back the Bank



# Regular vs. ESOP Debt Financing

	<u>Leveraged Redemption</u>	<u>Leveraged ESOP</u>
Gross Principal Payments	\$5,000,000	\$5,000,000
Value of Principal Tax Deduction	-	(2,000,000)
Net After-Tax Principal Paid	5,000,000	3,000,000

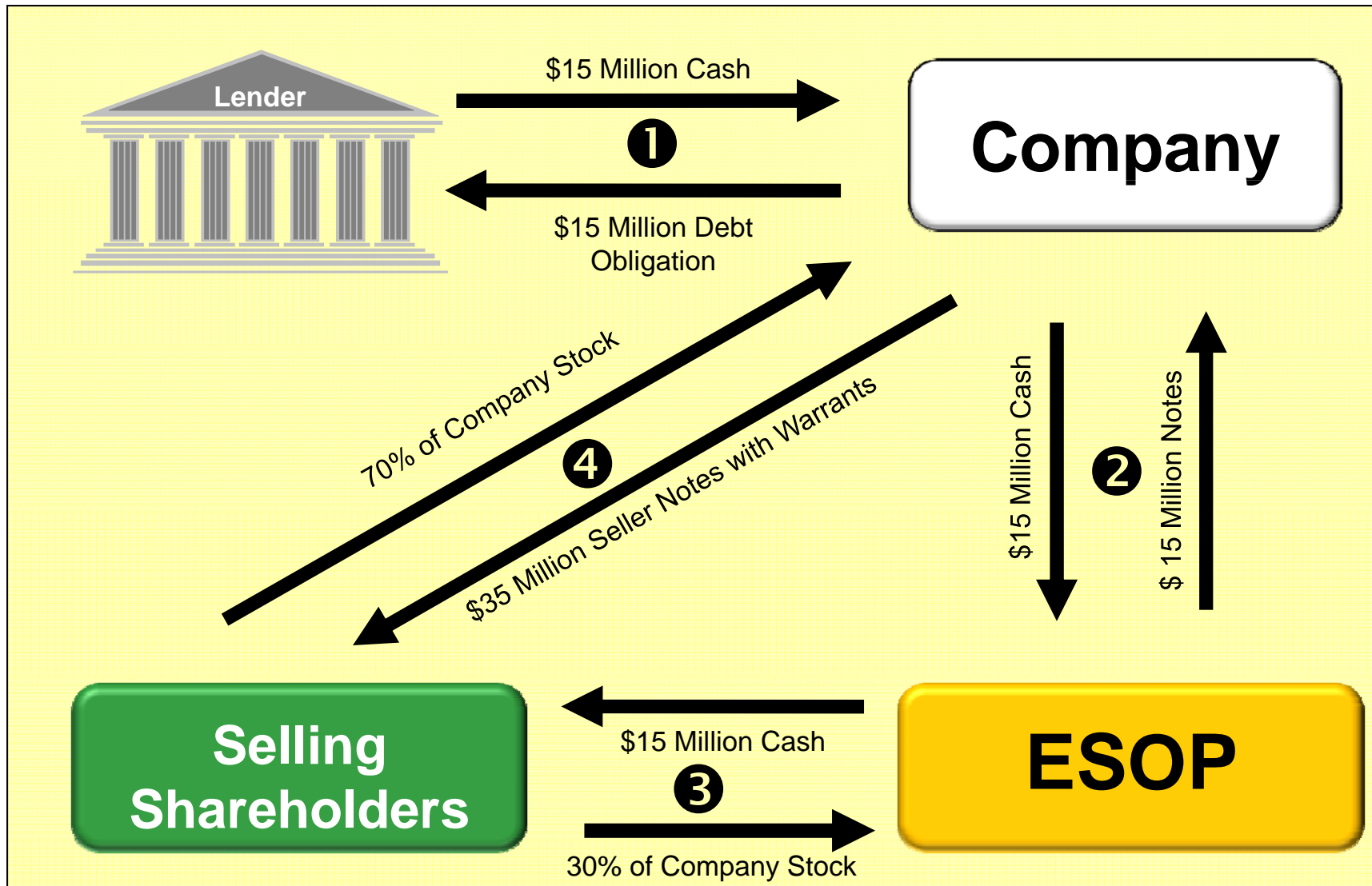
# Case II

- Profitable auto parts manufacturing company (S corp.)
- Two shareholders have owned the company for 12 years together:
  - CEO (in his early 50s) owns 60% and wants to continue for several years
  - Professional private investor owns 40%, wants to cash in
  - Both are seeking to sell 75%+ of their stakes
- Company is growing, has consistent cash flows and good collateral
- Shareholders are more interested in a financial buyer as opposed to a strategic buyer because the owners are concerned about the legacy, continued employment and impact on the local community

# Case II Solution

- Shareholders hired an investment bank on an exclusive basis to auction the company...
- ESOP had to pay a price that would be competitive with a private equity value
  - \$50 million equity value (MVIC = 7x EBITDA)
- 100% Leveraged ESOP Buyout
  - Shareholders received \$15 million “free and clear” cash from senior bank financing
  - Sellers also received subordinated notes of \$35 million (4% cash interest, warrants for 17%)
  - Sellers effectively remain in control of board so long as they have meaningful credit exposure to the company
  - Management receives Stock Appreciation Rights (SARs) for up to 15% of equity
  - Company is exempt from federal and state income taxes post -transaction!!!
- Private investor gifted warrants to his children and alma mater, thereby addressing a major estate planning objective
- Life insurance put in place to address several key funding needs
- Shareholders, management, employees and local community were ecstatic!

# 100% Leveraged ESOP Transaction



	2010	Day 1	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
<b>ASSETS</b>												
<b>Current Assets:</b>												
Cash and Investments	\$ 678	\$ 405	\$ -	\$ 1,639	\$ 5,982	\$ 11,343	\$ 6,047	\$ 5,311	\$ 9,449	\$ 24,036	\$ 41,190	\$ 56,185
Accounts Receivable	3,649	3,273	3,560	3,915	4,229	4,567	4,932	5,327	5,753	6,213	6,710	7,247
Inventory	6,642	7,044	7,709	8,478	9,156	9,889	10,680	11,534	12,457	13,453	14,530	15,692
Other	1,551	1,379	1,379	1,379	1,379	1,379	1,379	1,379	1,379	1,379	1,379	1,379
<b>Total Current Assets</b>	12,520	12,101	12,648	15,412	20,746	27,178	23,038	23,551	29,038	45,082	63,809	80,504
<b>Net PPE</b>	2,900	3,087	3,087	3,115	3,167	3,239	3,335	3,456	3,608	3,792	4,012	8,274
<b>Total Other Assets</b>	900	650	650	650	650	650	650	650	650	650	650	650
<b>Total Assets</b>	\$ 16,319	\$ 15,838	\$ 16,385	\$ 19,177	\$ 24,563	\$ 31,067	\$ 27,023	\$ 27,658	\$ 33,296	\$ 49,524	\$ 68,472	\$ 89,428
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>												
<b>Current Liabilities:</b>												
Line of Credit	\$ -	\$ 3,664	\$ 1,589	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Current Portion of Other LT Debt & Cap Leases	1,442	369	130	36	21	23	-	-	-	-	-	-
Current Portion of New Senior Bank Term Loan	-	2,680	2,831	2,991	3,160	3,338	-	-	-	-	-	-
Current Portion of Jr. Subordinated Note - Series B	-	-	-	-	-	8,750	8,750	8,750	767	-	-	-
Accounts Payable and Accrued Expenses	3,780	3,729	3,139	3,367	3,578	3,804	4,047	4,308	4,589	4,891	5,216	5,065
<b>Total Current Liabilities</b>	5,223	10,442	7,690	6,394	6,759	15,914	12,797	13,058	5,357	4,891	5,216	5,065
Other Long-Term Debt & Cap Leases - Net of Current	3,013	208	81	44	23	-	-	-	-	-	-	-
New Senior Bank Term Loan - Net of Current	-	12,320	9,489	6,498	3,338	-	-	-	-	-	-	-
Jr. Subordinated Note - Net of Current - Series B	-	35,000	35,000	35,000	35,000	26,250	14,187	1,535	-	-	-	-
<b>Total Liabilities</b>	8,235	57,970	52,260	47,936	45,119	42,164	26,984	14,593	5,357	4,891	5,216	5,065
<b>Stockholders' Equity:</b>												
Additional Paid-in-Capital	3,272	3,272	3,272	3,272	3,272	3,272	3,272	3,272	3,272	3,272	3,272	3,272
Treasury Stock/Warrant Buyout	-	(35,000)	(35,000)	(35,000)	(35,000)	(35,000)	(35,000)	(35,000)	(35,000)	(35,000)	(35,000)	(35,000)
Unearned ESOP Shares	-	(15,000)	(14,000)	(13,500)	(13,000)	(12,500)	(12,000)	(11,500)	(11,000)	(10,500)	(10,000)	(9,500)
Retained Earnings	4,812	4,595	9,853	16,469	24,171	33,131	43,767	56,293	70,667	86,860	104,984	125,591
<b>Total Stockholders' Equity</b>	8,084	(42,133)	(35,875)	(28,759)	(20,557)	(11,097)	39	13,065	27,939	44,632	63,256	84,363
<b>Total Liabilities and Stockholders' Equities</b>	\$ 16,319	\$ 15,838	\$ 16,385	\$ 19,177	\$ 24,563	\$ 31,067	\$ 27,023	\$ 27,658	\$ 33,296	\$ 49,524	\$ 68,472	\$ 89,428

# Seller Notes and Warrants (\$000)

<b>Seller Note IRR - Pre Transaction Taxes</b>											
	<u>Day 1</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6</u>	<u>Year 7</u>	<u>Year 8</u>	<u>Year 9</u>	<u>Year 10</u>
Principal Received/(Invested)	\$(35,000)	\$ -	\$ -	\$ -	\$ -	\$ 12,063	\$ 12,652	\$ 9,517	\$ 767	\$ -	\$ -
Interest Received	-	1,400	1,400	1,400	1,400	1,159	664	221	15	-	-
Equity Warrant Cash Out	-	-	-	-	-	-	-	-	-	-	37,064
Cash Inflow/(Outflow)	\$(35,000)	\$ 1,400	\$ 1,400	\$ 1,400	\$ 1,400	\$ 13,222	\$ 13,317	\$ 9,738	\$ 783	\$ -	\$ 37,064
						<b>Estimated Pretax IRR on Seller Financing</b>		<b>12%</b>			

<b>Black Scholes European Call Option Valuation</b>	
Stock price at Issuance	\$21.48
Strike price	\$21.48
Term of Warrant (In Years)	10
Risk-free rate	2.50%
Volatility	40.0%
European call value per warrant share	\$11.56
<b>Warrant</b>	
Number of Warrants/SARs Issued	35,598
<b>Black Scholes Value of Warrants at Issuance (\$000)</b>	<b>\$412</b>

# Case II Mission Accomplished

- Equity value objectives are met
- Shareholders remain in control until debt is paid down and there is no P/E investor
- ESOP trustee does not get involved in day-to-day or board participation
- Employees and management are charged up
- Legacy of the business is preserved
- \$15 million of upfront cash provides considerable wealth management options
- Warrants are incorporated into unique estate planning strategy
- Company no longer pays corporate income taxes!!!

# Case III

- Large multinational company needs cash and has hired sell-side banker to auction U.S manufacturing division
- Fatigue from the auction process is setting in
- Management team wants to make a bid
- Expected “clearing” value is \$50 million

# Case III Solution

- 100% S corporation ESOP buyout
- Company can borrow approximately \$20 million on a senior secured basis
- Sale-leaseback of manufacturing facilities will yield \$10 million
- Existing defined contribution pension plans have \$10 million that could be used for equity purchase of company
  - Proceeds are transferred from 401(k) to ESOP on a voluntary basis by plan participants
- \$10 million balance needed is provided by private equity firm (investment is structured as subordinated debt with warrants)

# Case III Sources & Uses

<b>Sources and Uses (\$MM)</b>			
<b><u>Sources</u></b>		<b><u>Uses</u></b>	
Balance Sheet Cash	\$ 1	ESOP Transaction Expenses	\$ 1
Senior Term Debt	20	100% Stock Purchase	<u>50</u>
Sale Leaseback	12		
Subordinated Note	10		
Equity (provided by pension plans)	<u>8</u>		
<b>Total</b>	<b><u>\$ 51</u></b>	<b>Total</b>	<b><u>\$ 51</u></b>

# Case III Mission Accomplished

- Management and employees control their own destiny and “put their money where their mouth is...”
  - Using existing 401(k) assets does require considerable care and will require investment disclosure
  - Repurchase obligation for ESOP stock can become accelerated given large “down payment” by ESOP
- Parent gets cash from a stock sale
- Company is exempt from corporate income taxes and can prepay debt rapidly
- Private equity gets board seat and targeted IRR of approximately 26%

# Sizing Up the ESOP as a Solution

- Transaction Analysis is a “Blue Print” that illustrates how the ESOP could work and what the impact is to various transaction constituents
- Foundation of the analysis is a forecasting model that drives value analysis and structuring
- Transaction Analysis Content:
  - Objective Statements
  - Value Estimate
  - Transaction Structure
  - Outcomes Analysis
  - Issue Identification

# Transaction Analysis Sample

Thank You!