

ESOPs: The Best Kept Secret in Business Succession Planning

Presented by:
Brian D. Bornino, CPA/ABV, CFA, CBA
Director of Valuation Services

Ohio Society of CPAs
September 5, 2007



About the Speaker


- 10+ years of valuation and ESOP experience, including:
 - 700+ valuation engagements
 - 250+ ESOP-related engagements
 - Leadership positions with national & regional valuation firms prior to joining GBQ
- Been involved with 6 ESOP formations in past 18 months
- Among the largest ESOP advisory practices in the Midwest
- Extremely active with the ESOP Association, Ohio Employee Ownership Center, and National Center for Employee Ownership
- Frequent speaker on valuation, M&A, and ESOP-related issues




Agenda


- Exit Strategies & Considerations
- What is an ESOP?
- Unique Benefits of ESOPs
- Is an ESOP Right for Your Company or Your Client?
- Case Studies
- Questions & Answers





Exit Strategies & Considerations





Possible Exit Strategies

Sale to Third Party


- Financial buyers
- Strategic buyers


Sale to Management

- Management buyout
- Employee Stock Ownership Plan (ESOP)

Transfer to Next Generation of Family

- Family gifts
- Voting / Non-voting recapitalizations





Selling a Company Can Be Very Difficult

Confidentiality Breaches Can Damage Business


- Word can spread quickly when a company is for sale
- May have difficulty being awarded new contracts/earning new business if company is for sale
- Competitors can use confidential information against you

Many Businesses are Personal in Nature

- Owners & managers often have all key relationships
- Reputations and relationships are difficult to transfer

May Not Be Attractive to Financial Buyers

- Many businesses have cyclical cash flows
- Many businesses are not scalable (e.g., limited geographically)
- Must be of a certain size to attract interest from financial buyers



Management Buyouts & ESOPs



Advantages:

- Confidential transaction
- Rewards existing management
- Owners can exit the business gradually
- Can still get fair market value
- Gradual sales are more financially feasible
- ESOPs can provide unique tax advantages to companies & selling shareholders
- *Relatively* short and inexpensive transaction process

Disadvantages:

- Must have strong management team in place for MBOs or ESOPs to be viable options
- Owners may have to remain active in the business longer than you prefer
- Banks may determine transaction amounts
- Cannot sell for a "strategic premium"



Transfers to Next Generation of Family



Advantages:

- Ability to keep business in the family
- Confidential transaction
- Rewards existing management & family members
- Owners can exit the business gradually & maintain compensation during transition period
- May be able to transfer ownership at discounted values

Disadvantages:

- Oftentimes owners do not achieve desired financial results
- Many family businesses fail under next generation
- Must have strong management team in place and capable next generation of family for family transfers to be viable options
- Owners may have to remain active in the business longer than you prefer



What is an ESOP?



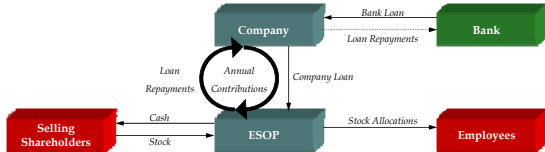
Definition of an ESOP

- Qualified Retirement Plan under ERISA
 - Analogous to 401(k) plan
 - Must meet various regulatory requirements to be "qualified"
- Designed to invest primarily in stock of sponsoring company
- Governed by Internal Revenue Code ("IRC") and Employee Retirement Income Security Act of 1974 ("ERISA")
- Exempt from certain ERISA "prohibited transaction" requirements
 - As a result, an ESOP can borrow funds from the sponsoring employer to purchase employer securities (i.e., a leveraged ESOP)



Typical Leveraged ESOP Transaction

1. The company borrows funds from the bank.
2. The company loans the proceeds from the bank to a newly created ESOP.
3. The ESOP uses the proceeds to purchase stock from the selling shareholders.
4. The company makes annual tax deductible contributions to the ESOP which are used to repay the loan to the company.
5. The company uses the cash received from the ESOP to repay its loan to the bank.
6. Stock is allocated annually to ESOP participants accounts.



Key ESOP Requirements

- Adequate Consideration
 - ESOPs cannot pay more than (or receive less than) fair market value for company stock
 - Cannot pay a strategic price as a financial buyer
 - Valuation determined by trustee with assistance from independent valuator
- Annual Administration of an ESOP
 - Valuation, trustee, TPA, attorney, etc.
- Repurchase Obligation
 - ESOP participants have a statutory right to "put" their shares back to the company upon retirement at the then-FMV; company must repurchase these shares (can be "recycled" or "repurchased")
 - Companies must plan for this repurchase obligation



ESOP Valuation



- Adequate Consideration
 - ESOPs cannot pay more than (or receive less than) fair market value for company stock
 - Cannot pay a strategic price as a financial buyer
 - Valuation determined by trustee with assistance from independent valuator
- Valuation Approaches
 - Market Approach (e.g., multiples from comparable companies)
 - Income Approach (e.g., discounted cash flow analysis)
 - Asset Approach (e.g., marked-to-market balance sheet)
- Other Factors in Valuation
 - Post-ESOP level of owner compensation
 - Post-ESOP levels of other expenses (e.g., profit sharing, etc.)
 - ESOP "put right" largely mitigates valuation discounts



ESOP Advisors



- Required:
 - ESOP trustee
 - ERISA attorney
 - Independent valuation advisor
 - Third party administrator
- Others Possibly Involved:
 - Financial advisor to the company/shareholders
 - ESOP lender
 - Investment professional (to invest QRP)



Unique Benefits of ESOPs



Growth in ESOPs



- There are ~11,000 ESOPs in the U.S.
 - More than 2x the number from 20 years ago!
 - ~400 ESOPs in Ohio
 - 10 million employees own ESOP shares
- ESOP Association member companies report:
 - 60% have ESOPs that have been in place for 10+ years
 - 82% have seen increases in employee motivation and productivity
 - Average contribution equals 13% of payroll
 - Average account balance is \$65,000



Benefits of an ESOP



- Shareholder Benefits:
 - Achieve liquidity & diversify wealth in relatively inexpensive manner
 - Maintain voting control of a business through a partial sale
 - Defer or eliminate capital gains tax on sale of stock
 - Sell part or all of ownership position
 - Provide a viable business succession tool
- Company Benefits:
 - Finance transaction with tax-deductible principal & interest payments
 - Potential for enhanced performance by motivated employees
 - Preserve legacy as independent company (i.e., no sale to a competitor)
 - Possible to create a tax-free entity if ESOP owns 100% of an S-corporation
 - Potential acquisition tool
- Employee Benefits:
 - Provide retirement benefit similar to 401(k); tax deferral on investment gains
 - Reward and motivate employees through ownership
 - Protect jobs by not selling to competitor



Unique Tax Benefits of ESOPs



- Tax Deferral of Capital Gain to Selling Shareholder (i.e., IRC 1042 Rollover):
 - ESOP must be sold 30%+ of stock
 - Must be a C-corporation
 - Must reinvest proceeds in "qualified replacement property" within 12 months of the sale; there are ways to gain access to this cash (i.e., floating rate notes)
 - Selling shareholder (& family) cannot participate in ESOP if 1042 is elected
- Tax-Deductible ESOP Contributions for the Company:
 - Contributions can be used to repay principal & interest payments (only tax-deductible principal around!)
 - Subject to various IRC limits (e.g., 25% of payroll + interest)
 - Dividends on ESOP shares are typically deductible as well
- Possible to Create a Tax-Free Entity:
 - Income tax can be completely avoided if an ESOP owns 100% of an S-corporation
 - Subject to various anti-rules (e.g., IRC 409p)
- Tax Deferral on Investment Gains to Participants (similar to 401(k))



When do ESOPs Go Wrong?



- Business Unexpectedly Deteriorates
 - Inability to service ESOP loan
 - Stock price plummets
- ESOP Overpays in Initial Transaction
 - Inability to service ESOP loan
 - DOL challenges; ERISA breaches; participant lawsuits
- Transitioning to the Next Generation
 - Next generation of management unwilling "inherits" the ESOP
 - Mature ESOPs with no remaining stock to allocate ("haves" and "have-nots")
- Poor Corporate Culture
 - Non-participative management style
 - ESOP was done for purely tax purposes
- Inexperienced or Overly Aggressive ESOP Advisors
 - Recipe for successful ESOP starts with good advisors
 - Experience with ESOP transactions is critical



Is an ESOP Right for Your Company or Your Client?



Attributes of a Good Candidate for an ESOP



- Strong management team
- Debt capacity
 - Strong and steady cash flows
 - Strong balance sheet
- Shareholders are willing to accept Fair Market Value (rather than shop the company to competitors for top dollar)
- Shareholders have low basis in company stock
 - Enhanced the attractiveness of 1042 rollover
- Shareholders have interest in company's future success
 - Maintain legacy as independent company
 - Maintain family ownership



Attributes of a Good Candidate for an ESOP, cont.



- Loyalty toward Employees
 - Job security; do not want them to be subject to a new owner's desires
- Desire to reward management and/or employees with ownership
- Limited family participation in the business
 - Cannot participate in ESOP if family member took a 1042 deferral
 - Many family members want 100% ownership and control
- Desire to sell only a portion of the company
- Open book management style; healthy corporate culture
- Desire for tax-advantaged acquisition financing



How GBQ Structures a Typical Valuation Engagement



- Step 1: Brief Introductory Meeting / ESOP Feasibility Analysis
- Step 2: Preliminary Valuation Analysis
- Step 3: Formal Valuation Opinion and Report
 - Step 3a: Assemble the ESOP Team [optional]
 - Step 3b: Raise the Necessary Financing [optional]
- Step 4: Transaction Letter/Fairness Opinion at Closing



Case Studies



Case Study #1: Sale of 49%



Facts:

- Equity Value = \$15.0 million
- Type of Entity: S Corporation (AAA = \$2.0 million)
- Family business with son being groomed to run the company
- Shareholder Objective: Maintain family control of the business indefinitely, but find a way for aging shareholders to diversify their wealth since 90% of their wealth was tied up in the business (i.e., take some "chips off the table")

Transaction:

- Strip out S-corporation AAA using seller I/O seller note; equity value is now \$13 million
- Convert to C-corporation
- Sell 49% of Company stock to ESOP for \$6.5 million
 - Financed by "outside loan" from bank loan to company and "inside loan" from company to ESOP
 - Shareholders elect 1042 deferral of capital gain and invest in QRP within a year
- ESOP shares are "recycled" such that ESOP owns 49% forever; shareholder eventually transfers 51% to son



Case Study #1: Net Results



- Shareholder Diversification
 - Monetized an otherwise illiquid investment
 - \$6.5 million in cash at closing; shareholders paid no tax on capital gain (1042 rollover)
 - Interest on \$2.0 million until bank loan is repaid, then principal payments begin
- Maintain Family Control of the Business
 - Shareholders maintained voting control of the business; nothing changed (rent, compensation, etc.)
 - Shareholders began program to transfer other 51% to son
- Family Business is Preserved; Employees are Rewarded
 - Company remains independent; employees remain intact
 - Employees are rewarded and motivated with ownership
 - Company will repay debt with pretax dollars; debt burden is manageable
- Relatively Simple & Inexpensive Transaction (relative to strategic sale)
 - Consummated in 90 days
 - Total cost was approximately \$100,000



Case Study #2: Sale of 100%



Facts:

- Equity Value = \$2.0 million
- Type of Company = C Corporation
- Shareholder Objective = Exit the business entirely & sell to employees; do not want to sell to competitor for variety of reasons

Transaction:

- Sell 100% of Company stock to employees through ESOP for \$2.0 million
 - Finance \$1.5 million with "outside loan" from bank loan to company and "inside loan" from company to ESOP
 - Finance the remaining \$0.5 million with a note from the sellers; interest-only until the bank loan is repaid
 - Shareholders elect 1042 deferral of capital gain and invest in QRP within a year
- Convert to S-corporation status immediately after transaction
 - Company is now tax-free since sole shareholder is a tax-exempt trust
 - Tax savings is used to repay ESOP debt and grow the business



For More Information



- ESOP Association
- National Center for Employee Ownership
- Ohio Employee Ownership Center
- GBQ Consulting



Questions & Answers



Thank You!



Brian D. Bornino, CPA/ABV, CFA, CBA
Director of Valuation Services

(614) 221-1120
bbornino@gbq.com
www.gbq.com