

A black and white photograph of two hands shaking in a firm grip, symbolizing a business deal or agreement. The hands are wearing suit sleeves.

ESOPs: A Savvy Business Succession Strategy

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Speakers



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Introduction to GBQ's ESOP Advisory Practice

Market Leader

GBQ has a national valuation and ESOP advisory practice. We complete 300+ valuation and 100+ ESOP engagements annually. Since our inception in 2005, we have been involved with 3,000+ valuation engagements and 1,000+ ESOP engagements.

Experienced

Our professionals have dedicated their careers to the valuation and ESOP advisory industries and have completed 10,000+ valuations and financial opinions and 2,000+ ESOP engagements during the course of their careers.

Recognized

Our team includes recognized thought leaders in the ESOP industry. We are frequent speakers on valuation and ESOP-related topics for various professional organizations and educational institutions (e.g., ESOP Association, National Center for Employee Ownership, etc.) on a local, regional, and national basis.

Credentialed

Our professionals have earned a variety of professional designations related to valuation, finance, and accounting. We hold leadership positions in various ESOP-related organizations.

GBQ's ESOP Advisory Services

Pre-ESOP Planning and Evaluation

- Assessment of Alternatives
- ESOP Feasibility Studies
- Preliminary Valuation
- ESOP Transaction Illustrations
- ESOP Consulting

ERISA Compliance

- Annual Valuations
- Trustee Advisory
- ESOP Transactions
- Valuation Report Review

ESOP Formation

- Initial Valuation
- Trustee Representation
- Company Representation
- Transaction Structuring & Financing
- Fairness & Solvency Opinions

Mature ESOP Planning

- ESOP Sustainability Assessments
- Transaction Advisory
- ESOP Terminations
- Fairness Opinions

Agenda

- How ESOPs Work & Unique Benefits of ESOPs
- Importance of Valuations in ESOP Transactions
- ESOP Transaction Process
- Next Step: ESOP Feasibility Study
- Case Studies





ESOPs: A Savvy Business Succession Strategy

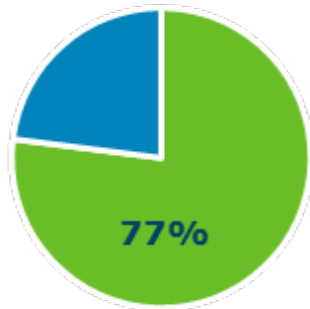
How ESOPs Work & Unique Benefits of ESOPs

What is an ESOP?

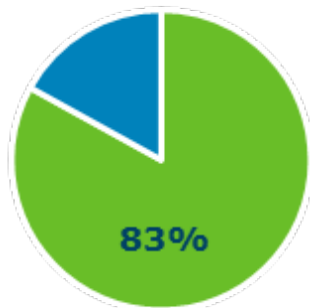
- An ESOP is an Employee Stock Ownership Plan
- An ESOP is a vehicle, in the form of a qualified ERISA plan, that allows business owners to sell their ownership to their employees, and allows employees to enjoy ownership in the companies where they work
- The selling shareholders sell stock to the ESOP in exchange for cash (typically provided from a bank or notes to the seller)
- ESOP shares are allocated to participants over time
- Participants cash out ESOP shares for fair market value when they retire

ESOPs are Usually Successful

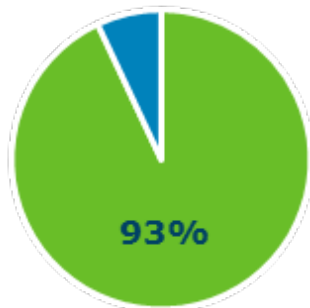
Source: Employee Ownership Foundation 24th Annual Performance Survey



- **77%** of ESOP companies report that their ESOP improved employee productivity



- **83%** of ESOP companies report that their ESOP stock value increased in the past year



- **93%** of ESOP companies report that creating employee ownership through an ESOP “was a good business decision that has helped the company”

ESOPs Help Business Owners Achieve Various Goals

<u>Owner Objective</u>	<u>3rd Party Sale</u>	<u>MBO</u>	<u>ESOP</u>
Build/Preserve Legacy	??	YES	YES
Assure Financial Security	YES	??	YES
Flexibility/Control Timing of Transaction	??	YES	YES
Ownership Culture	??	??	YES
Minimize Taxes	??	??	YES

Primary Benefits of ESOP

Financial

- Can create income tax free company (if 100% ESOP owned)
- Tax-deductible financing (including principal)
- Tax savings finance large portion of transaction
- Stock sale (favorable tax treatment)
- Potential for tax-free rollover
- Sellers can participate in ESOP
- Opportunity for additional return through interest, warrants, SARs

Non-Financial

- Unique ownership transition alternative tool that preserves a company's legacy
- Sellers can retain operational control of the business
- Reward, attract, retain and motivate employees
- Flexible; can customize ESOP
- Low "transaction risk"; ESOP transactions almost always close
- Productivity gains are likely
- Tax/cash flow savings can facilitate growth

Common ESOP Transaction Structures

One-Time Sale of Minority Ownership Interest to ESOP

- Common when there is a desire for some employee ownership, but family or key executives require controlling ownership
- Allows seller to “take chips off the table” and diversify wealth while maintaining voting control of the business

Multiple Transactions to Eventually Achieve 100% ESOP Ownership

- Common with owners that want to gradually exit the business
- Common with owners that want to participate in “upside” of business

Sale of 100% to the ESOP

- More common than ever
- Company immediately benefits from being income-tax free
- Selling shareholders often receive notes as part of their consideration
- Seller notes can be attractive investments for sellers

Parties Involved in an ESOP Transaction

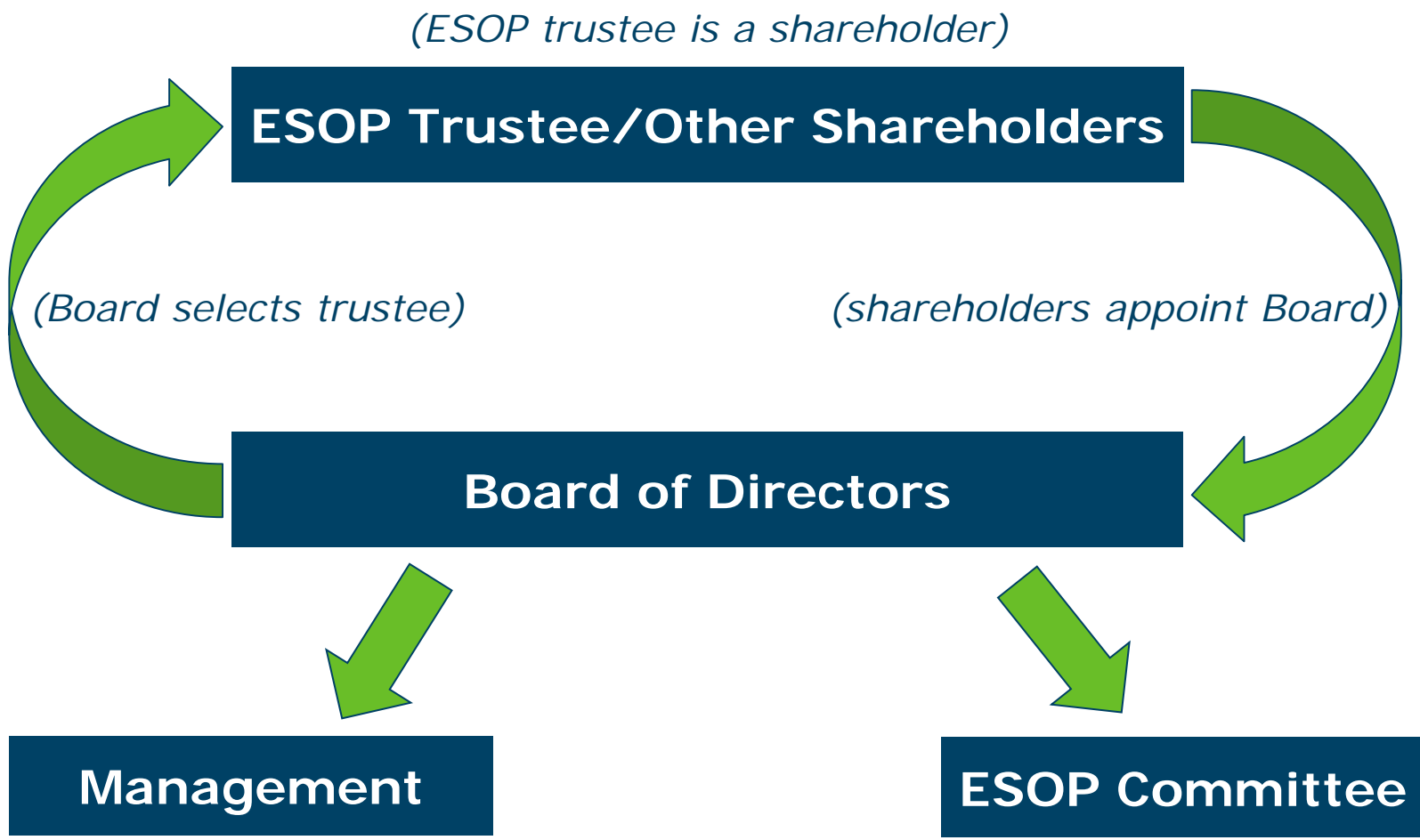
ESOP's Advisors

- ESOP Trustee
- Independent Valuator
- Trustee's Counsel

Company's Advisors

- ESOP Deal Quarterback / Financial Advisor
- ESOP Attorney
- Third-Party Administrator
- CPA Firm

Corporate Governance in an ESOP Company



Typical ESOP Characteristics

Participation

- ESOPs are inclusive; generally, everyone participates
- Typical ERISA rules apply (18 years of age, 1,000 hours of service)

Allocation

- Shares may be allocated based on compensation or combination of compensation & tenure
- Plan cannot be “top-heavy” or discriminatory

Vesting

- Can have a maximum of 3-year cliff or 6-year graded vesting schedule
- Can give “credit” for service-to-date

Repurchase

- Shares must be purchased on a non-discriminatory basis
- Can defer payments until ESOP loan is repaid and pay out over 5 years

Attributes of a Good Candidate for an ESOP

- Desire to preserve legacy as independent company
- Desire to reward employees with ownership, opportunity, and job security
- Strong management team
- Strong cash flows and debt capacity
- Shareholders are willing to accept Fair Market Value
- Desire to control timing of succession or sell a portion of the company
- Open-book management style; healthy corporate culture
- Desire for tax-advantaged financing

The Three Deal-Breakers for ESOP Transactions

- Poor management team
- Financially struggling / No additional debt capacity
- Unwilling to provide broad ownership to employees

The top portion of the slide features a grayscale photograph of the United States flag waving on the left, with the dome of the United States Capitol building visible in the background on the right. Below the photograph is a solid green horizontal bar.

ESOPs: A Savvy Business Succession Strategy

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Importance of Valuations in ESOP Transactions

How Valuations Work in ESOPs

- ERISA prohibits ESOPs from paying more than (or receiving less than) adequate consideration (i.e., fair market value) for company stock
- ESOP transactions are negotiated between the sellers(s) and the ESOP trustee. As the buyer, the trustee (with help from an ESOP valuation firm), ultimately determines how much an ESOP can pay (by determining their opinion of fair market value)
- Selling shareholders will not see the ESOP trustee's valuation analysis, nor will they know the maximum price the ESOP can pay. As such, it is helpful for selling shareholders to have an experienced ESOP financial advisor "on their side"
- The DOL has repeatedly and aggressively challenged prices paid (and other financial terms) in ESOP transactions
- ESOP companies are valued every year. The annual ESOP valuations determine the value of participants' accounts and any payouts

Fair Market Value

Definition of FMV:

The price at which an asset would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties being able, as well as willing, to trade and well-informed the asset and the market for the asset.

- Title I of ERISA and the Proposed Regulation Relating to the Definition of Adequate Consideration (Prop. Reg. Section 2510.3-18(b)(2)(i))

Key Concepts

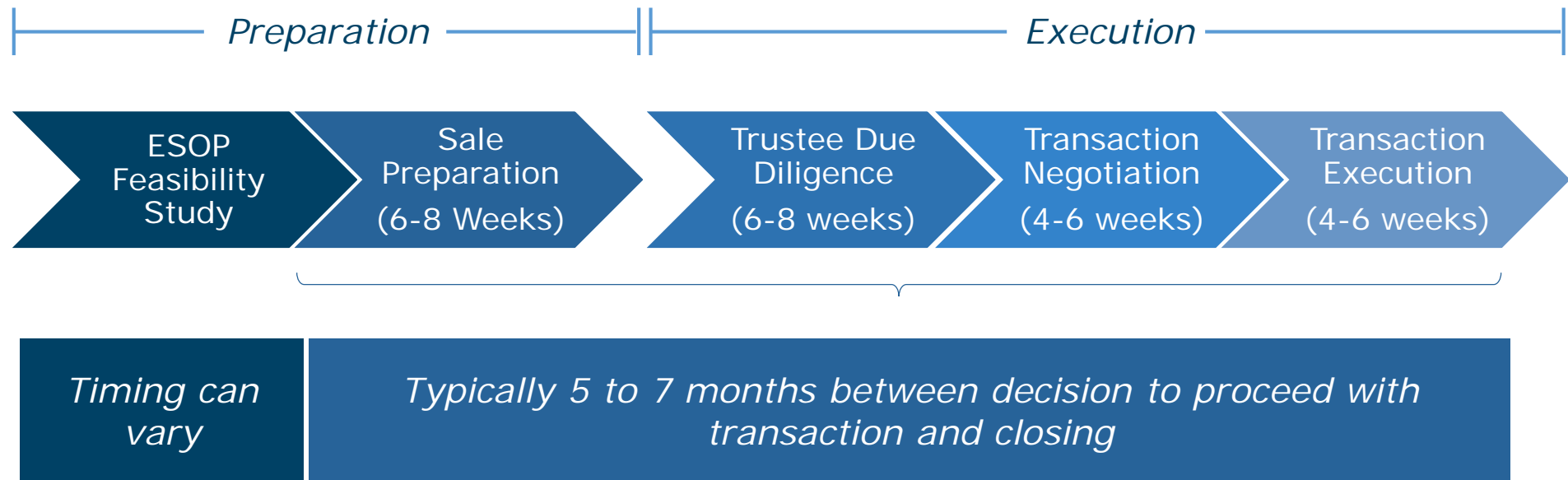
- Arm's-length transaction
- Hypothetical buyer and seller
- No undue influence to buy or sell
- Knowledgeable buyer and seller
- ESOP is a financial buyer



ESOPs: A Savvy Business Succession Strategy

ESOP Transaction Process

Sample ESOP Transaction Timeline



Sample ESOP Transaction Timeline

ESOP
Feasibility
Study

Sale
Preparation
(6-8 Weeks)

Trustee Due
Diligence
(6-8 weeks)

Transaction
Negotiation
(4-6 weeks)

Transaction
Execution
(4-6 weeks)

- Comprehensive valuation analysis
- Evaluate transaction financing alternatives
- Evaluate synthetic equity or management incentive plans
- Post-transaction cash flow analysis
- Illustration of seller proceeds
- Illustrations of benefit levels to management and employee
- Make decision to proceed

Sample ESOP Transaction Timeline

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Transaction
Execution
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- Draft confidential information memorandum
- Help management finalize financial forecast
- Update valuation analysis
- Design plan features
- Discuss/interview/engage trustee team
- Interview/engage ESOP attorney
- Legal sale prep work
- Draft initial letter of intent

Sample ESOP Transaction Timeline

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Preparation
(6-8 Weeks)

Trustee Due
Diligence
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Transaction
Negotiation
(4-6 weeks)

Transaction
Execution
(4-6 weeks)

- Deliver confidential information memorandum to trustee team for review
- Trustee team document and information gathering
- On-site due diligence meeting with management and trustee team
- Assist trustee team with responses to their questions

Sample ESOP Transaction Timeline

ESOP
Feasibility
Study

Sale
Preparation
(6-8 Weeks)

Trustee Due
Diligence
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Transaction
Negotiation
(4-6 weeks)

Transaction
Execution
(4-6 weeks)

- Present letter of intent to trustee team
- Negotiate purchase price and other terms of transaction (synthetic equity, MIPs, SARs, etc.)
- Negotiate terms of bank financing
- Agree to transaction terms
- Finalize letter of intent

Sample ESOP Transaction Timeline

ESOP
Feasibility
Study

Sale
Preparation
(6-8 Weeks)

Trustee Due
Diligence
(6-8 weeks)

Transaction
Negotiation
(4-6 weeks)

Transaction
Execution
(4-6 weeks)

- Draft transaction documents
- Execute bank financing
- Draft/execute plan documents
- Close transaction
- Communicate/roll-out ESOP to employees

A black and white photograph of two hands shaking in a firm grip, symbolizing a business agreement or partnership. The hands are wearing white dress shirts with visible cuffs.

ESOPs: A Savvy Business Succession Strategy

Next Step: ESOP Feasibility Study

Are You in this Situation?

- Your initial research indicates that an ESOP may be a viable choice for your business (or your client's business). You have read articles, attended seminars and talked to advisors.
- Now, you want to *really* evaluate the ESOP option.
- A logical next step is an **ESOP Feasibility Study**.

Benefits of GBQ's ESOP Feasibility Studies

- GBQ will conduct a valuation analysis with the same rigor and approach as the ESOP Trustee's valuation firm
- This approach: (a) produces realistic indications of value that a trustee is likely to accept, and (b) maximizes value by identifying and communicating factors that enhance and drive value and mitigate risk
- Solidify and evaluate forward-looking financial forecast
- Offer suggestions/insights on value drivers and how to maximize value (within the context of FMV) in an ESOP transaction
- Quantify impact of various factors on valuation (e.g., comp, SARs)
- Assess is timing is right for an ESOP (from a valuation perspective)



ESOPs: A Savvy Business Succession Strategy

Case Studies



Case Study #1: Midwest A&E Firm Sells 100% interest to ESOP for \$22 million in 2013

Situation:

- Company stats: \$50m revenue, \$4.0m EBITDA; 200 employees (15 shareholders)
- Many shareholders with different exit timelines
- More employees ready for ownership (shared success model)
- No desire to sell to 3rd party; want to preserve legacy; growth potential

Solution:

- Sold 100% of ownership to newly-formed ESOP for FMV of \$22m
- Bank financing of \$8m; seller financing of \$14m
- Longer horizon or larger shareholders took on more seller financing
- Key management incentivized with synthetic equity (SARs)
- Shares allocated to employees over 20-year period

Case Study #1: Midwest A&E Firm Sells 100% interest to ESOP for \$22 million in 2013 (cont'd)

Net Result (6 Years Later):

- No federal income tax liability → Seller notes repaid in 2019, looking at acquisition opportunities and new offices
- Company enterprise value now \$35m (8% annual growth)
- Company set up for long-term success

Case Study #2: West Coast A&E Firm Uses 3-Step ESOP Transaction over 8 Years

Situation:

- Company stats (in 2010): \$22m revenue, \$2.5m EBITDA; 90 employees
- Two equal owners, both active and with following goals:

- 10-year ownership transition plan	- Monetize ownership to diversify wealth
- Maintain control as long as possible	- Reward, attract, retain employees

Solution:

- Three transactions over 8 years:
- 2010 – Sold **30%** for \$4.0m (\$15m valuation; repaid bank loan in 4 years)
- 2015 – Sold **19%** for \$3.7m (\$19.5m valuation; repaid bank loan in 3 years)
- 2018 – Sold **51%** for \$12.5m (\$25m valuation; \$8m bank & \$4.5m seller-financed)

Case Study #2: West Coast A&E Firm Uses 3-Step ESOP Transaction over 8 Years (cont'd)

Net Result (8 Years Later):

- Transactions #1 & #2 financed with pre-tax dollars (company was a C-Corp)
- Company elected S-Corp status after Transaction #3 and is now 100% ESOP-owned, income tax-free company
- Owners participated in valuation increases
- All objectives above achieved; now a model ESOP company with outstanding culture

Questions?



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