

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

ESOPs: A Strategic Alternative for Ownership Transition in a post- COVID-19 Environment

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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

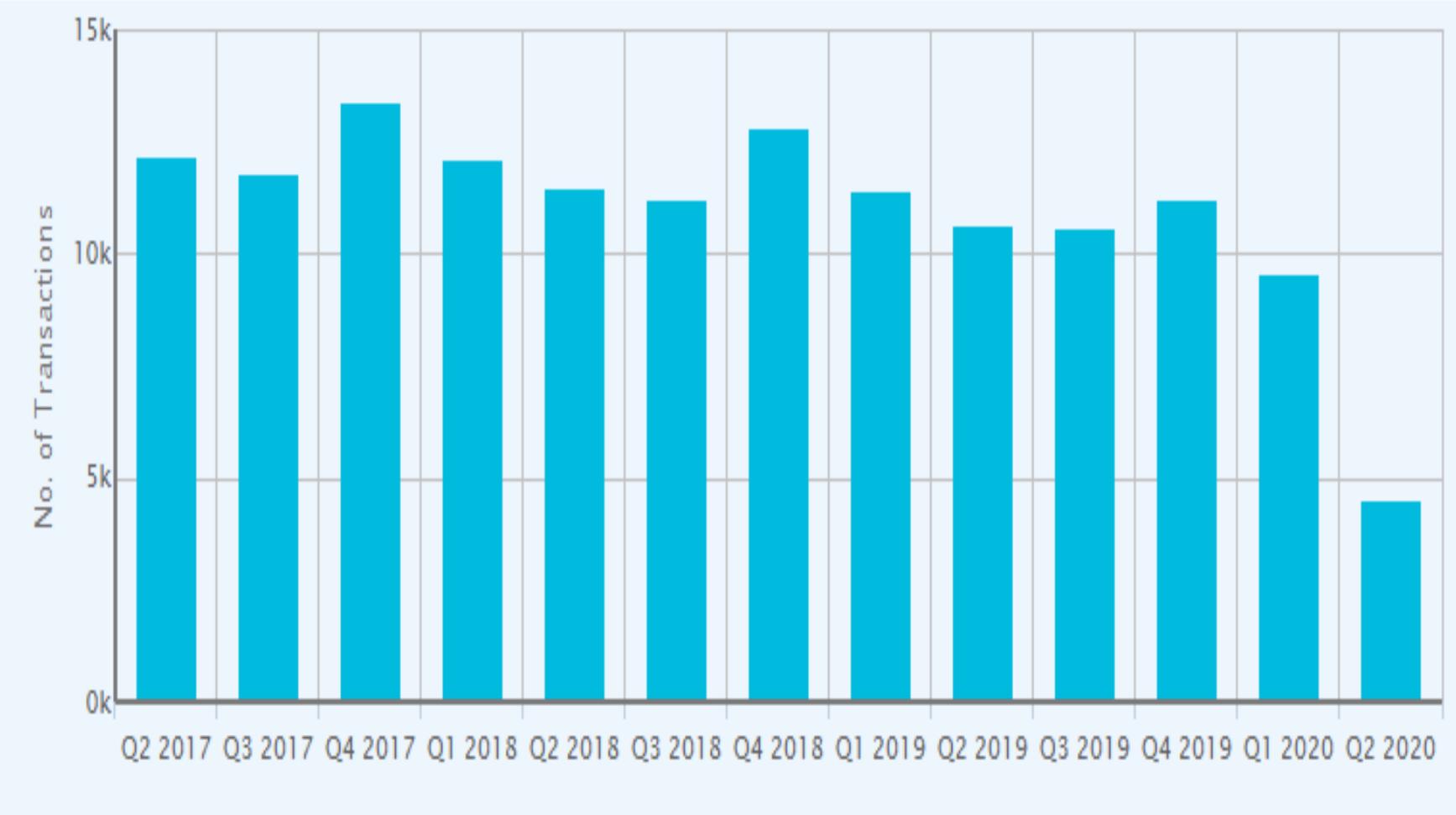
- Initial Valuation
- Trustee Representation
- Company Representation
- Transaction Structuring & Financing
- Fairness & Solvency Opinions

Mature ESOP Planning

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

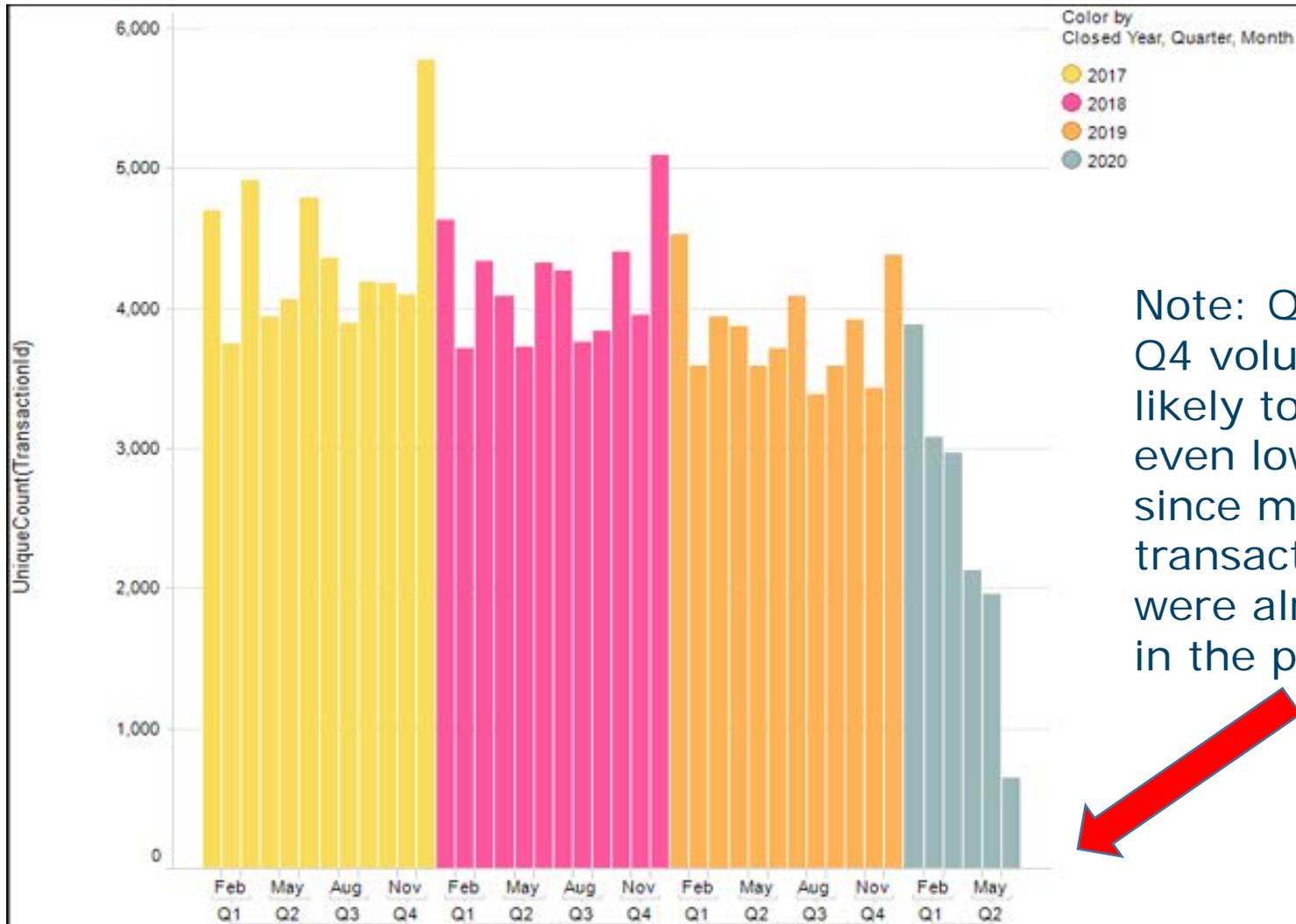
M&A Transaction Volume by Quarter

Source: S&P Capital IQ

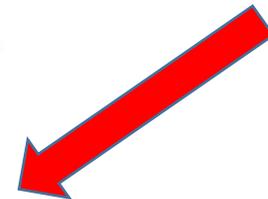


M&A Transaction Volume by Month

Source: S&P Capital IQ



Note: Q3 and Q4 volume likely to be even lower since many Q2 transactions were already in the pipeline



Common Reasons M&A Transactions Fall Apart

Reason	Explanation	How an ESOP Can Help
Valuation	<ul style="list-style-type: none">• Buyer and seller cannot agree on a purchase price• Unreasonable expectations (by either party)	
Culture	<ul style="list-style-type: none">• Incompatible cultures• Concerned about changes for management and employees	
Buyer Backs Away	<ul style="list-style-type: none">• Buyers back out of transactions for a variety of reasons, including:<ul style="list-style-type: none">• Findings in due diligence• Change in corporate priorities• Inability to finance• Changes in market conditions• Changes in target's performance• Get "cold feet"	

Agenda

- How ESOPs Work & Unique Benefits of ESOPs
- ESOP Transactions as an Alternative to Traditional M&A
- The ESOP Transaction Process
- Case Study
- Next Steps



A black and white photograph of a businessman in a suit and tie, holding a magnifying glass over a folder of papers. The image is partially obscured by a green horizontal bar at the bottom.

How ESOPs Work & Unique Benefits of ESOPs



ESOPs: The Big Picture

- Sale of 100% of stock (typically) to employees via the ESOP
- Sellers receive fair market value over time, plus a fair interest rate on their seller financing
- Operational control and management of the company does not change with an ESOP
- Company legacy is preserved; employees and management are protected and jobs are retained
- The ESOP structure can create a 100% income tax-free entity
- Improved ability to attract, reward, and retain employees

What is an ESOP?

- ESOP stands for Employee Stock Ownership Plan
- An ESOP is a qualified retirement plan under ERISA
- Selling shareholders sell stock to the ESOP in exchange for cash (typically provided from a bank) and/or notes to the seller
- ESOP shares are allocated to participants over time
- All employees who meet eligibility requirements will receive shares
- Participants cash out ESOP shares for fair market value when they retire

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

Key Financial Benefit

S Corporation ESOP Tax Savings

	<u>Non-ESOP Company</u>	<u>ESOP Company</u>
Revenue	\$ 31,500,000	\$ 31,500,000
Operating Expenses	<u>(27,870,000)</u>	<u>(27,870,000)</u>
Pre-Tax Income	3,630,000	3,630,000
<i>Less: Effective Income Tax Burden</i>	<u>(1,270,500)</u>	<u>-</u>
Income Retained in Business	2,359,500	3,630,000
<i>Improvement in Cash Flow</i>	<i>1,270,500</i>	<i>53.8%</i>

ESOPs Help Business Owners Achieve Various Goals

<u>Owner Objective</u>	<u>Third 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
Maintain Operational Control	NO	??	YES
Build Ownership Culture	??	??	YES
Retain and Reward Employees	??	??	YES
Minimize Taxes	??	??	YES

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

**Note: GBQ often serves in one of these two roles*

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

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
- Shareholders have interest in company's future success
- 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

The Three Deal-Breakers for ESOP Transactions

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

Abundant Data Shows that ESOPs Outperform

Sources: Various Studies and Surveys on Employee Ownership & ESOPs

78%

of ESOPs report increased revenue last year

Company Performance Before and After ESOP

Measure	Before ESOP	After ESOP	ESOP Advantage
Employment Growth	1.21%	5.05%	4.2x
Sales Growth	1.89%	5.40%	2.9x

Workers with employee ownership had layoffs

6X less often

than those without employee ownership

72% of workers want to work for employee owned companies

Employee turnover can be **3X lower** in ESOP companies

70% of ESOP company employees are heavily involved or somewhat involved in expense reduction initiatives

70%

of ESOPs report increased net profit last year

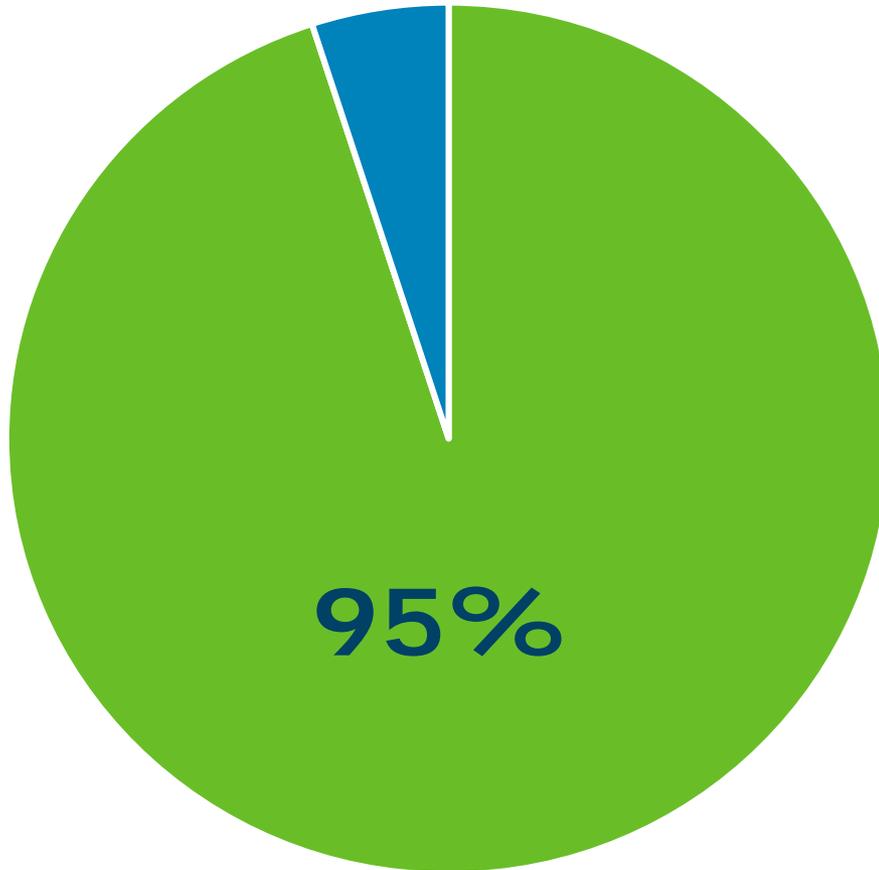
Avg. Retirement Savings: ESOP vs. Non-ESOP Employees

Employee Age	ESOP Employee	Non-ESOP Employee	ESOP Advantage
Under 25	\$ 5,617	\$ 2,740	105%
25-34	\$ 50,722	\$ 12,405	309%
35-44	\$ 179,716	\$ 37,039	385%
45-54	\$ 373,940	\$ 91,054	311%
55-64	\$ 426,098	\$ 142,124	200%
65 and Older	\$ 325,641	\$ 108,363	201%

38% of customers say they are more likely to buy from employee-owned companies

Bottom Line: ESOPs are Usually Successful

Source: Employee Ownership Foundation Annual Performance Survey



95% of ESOP companies report that creating employee ownership through an ESOP “was a good business decision that has helped the company”



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ESOP Transactions as an Alternative to Traditional M&A

How an ESOP Transaction can Overcome Common Reasons M&A Transactions Fall Apart

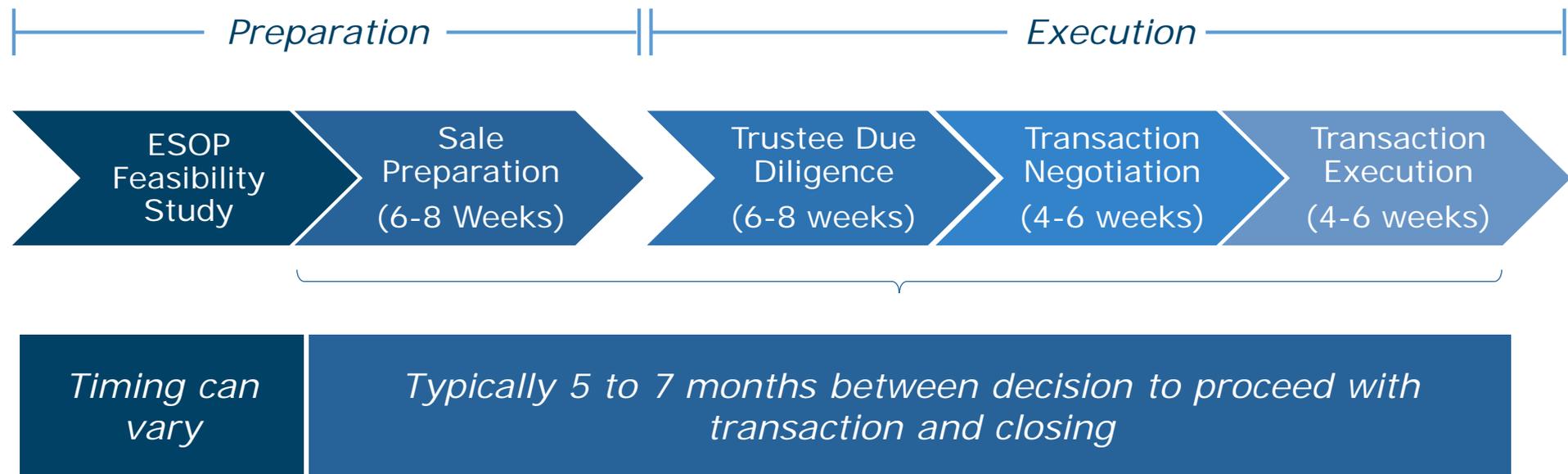
Reason	Explanation	How an ESOP Can Help
Valuation	<ul style="list-style-type: none"> • Buyer and seller cannot agree on a purchase price • Unreasonable expectations (by either party) 	<ul style="list-style-type: none"> • A good ESOP feasibility study (prepared by a firm with experience representing ESOP trustees) will: (a) properly set expectations and (b) be credible with ESOP trustees and independent ESOP valuation firms
Culture	<ul style="list-style-type: none"> • Incompatible cultures • Concerned about changes for management and employees 	<ul style="list-style-type: none"> • Culture does not change post-ESOP since same individuals run the company • No risk to management or employees
Buyer Backs Away	<ul style="list-style-type: none"> • Buyers back out of transactions for a variety of reasons, including: <ul style="list-style-type: none"> • Findings in due diligence • Change in corporate priorities • Inability to finance • Changes in market conditions • Changes in target's performance • Get "cold feet" 	<ul style="list-style-type: none"> • The "close rate" for ESOP transactions is extremely high • ESOP trustees rarely back out of potential ESOP deals (typically, when proposed terms are unreasonably aggressive) • A ESOP "deal quarterback" dramatically increases the likelihood of successful closing



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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 & employees
- Comparison to third party sale
- Make decision to proceed

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 if timing is right for an ESOP (from a valuation perspective)

Sample ESOP Transaction Timeline

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Transaction
Execution
(4-6 weeks)

- 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

ESOP
Feasibility
Study

Sale
Preparation
(6-8 Weeks)

Trustee Due
Diligence
(6-8 weeks)

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
(6-8 weeks)

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

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Case Studies

Case Studies

- **A/V Company Becomes 100% ESOP:**
 - Attempt to sell company failed due to incompatible cultures with buyer
 - Sold to ESOP for comparable net proceeds to third party sale to a strategic buyer (price was lower, but favorable ESOP tax treatment largely offset)
 - Management and employees are now owners; company culture is preserved and company continues as an independent enterprise
- **Specialty Contractor Currently Implementing 100% ESOP:**
 - Had offer to acquire company for \$14.5 million (i.e., 5.5x LTM EBITDA)
 - In April 2020, buyer reduced offer to \$7.5 million (due to temporary decline in EBITDA)
 - Company is currently pursuing an ESOP; we believe purchase price will be in the \$12-14 million range and will close by 12/31/20
- **Engineering Firm Sells 100% to ESOP:**
 - Key shareholders wanted to retire, but reluctant to sell to competitor
 - Sale to employees through ESOP created sustainable ownership model
 - Structure facilitates cash flow savings for growth
 - Ownership culture permeates all levels of the company



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Takeaways and Next Steps

Is Your Company Firm in this Situation?

- ✓ Seeking a more sustainable ownership model
- ✓ Desire to reward employees and provide growth opportunities
- ✓ Shareholders want to receive fair market value for the business
- ✓ Wish to preserve the company's legacy

Then it could be time to pursue one of two options...

If you're unfamiliar with the ESOP concept and want to learn more, then contact us for a **complimentary consultation**

If you've done some initial research and found an ESOP may be a viable choice for your business, a logical next step is an **ESOP Feasibility Study**.

Questions?



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