GBQ Consulting

VALUATION OBSERVATIONS

Dispelling the Myths about ESOPs

Being highly active in the Employee Stock Ownership Plan (“ESOP”) community for the past few decades, it has become commonplace for us to hear advisors perpetuate misunderstandings about ESOPs. Unfortunately, these myths are often accepted as the truth by business owners and prevent many acceptable companies from becoming employeeowned. This article will identify and rebut what we believe are the most common myths and misunderstandings about ESOPs.

Myth #1: Selling Shareholders “Leave Money on the Table” when Selling to an ESOP

Many shareholders are reluctant to sell their shares to an ESOP because of their misconception, and perhaps the misconceptions of their professional advisors, that sales to ESOPs are not financially advantageous and that the seller is effectively “leaving money on the table” with this type of transaction.

ESOP myths are often accepted by owners and prevent many acceptable companies from becoming employee-owned.

On the contrary, selling shareholders can often generate greater net proceeds with an ESOP sale than with a traditional transaction due to the following factors:

- **Capital Gains Tax Treatment.** The vast majority of traditional business sales are structured as asset deals. Therefore, any appreciation in these assets is taxed at the ordinary income tax rate. Conversely, a sale to an ESOP results in favorable capital gains tax treatment (because it is a stock sale). At today’s income tax rates, this factor often results in a financial advantage of up to 20% or more. Better yet, it is possible to qualify for a “Section 1042 Rollover”, whereby the sellers would defer all capital gains tax on the sale if certain conditions are met.
- **Interest on Seller Financing.** If the selling shareholders are willing to finance the transaction rather than utilize bank financing, they can earn a fair rate of interest on their loan. “Locking in” an interest rate of, say, 6% to 10% can be a more attractive return than gambling in the stock market, especially in today’s volatile financial environment.
- **Potential to Participate in the ESOP.** Depending on how the transaction is structured, the selling shareholders may be able to participate in the ESOP, thus accumulating shares over time that may be sold to the ESOP in the future.
- **Fair Market Value.** ERISA allows an ESOP to pay up to “adequate consideration” (i.e., fair market value) for the shares it purchases. Fair market value in an ESOP transaction will be determined by an ESOP trustee with the guidance and advice from an independent valuation firm that specializes in ESOP valuations.

Dispelling the Myths about ESOPs (continued)

In a previously published GBQ Valuation Observations article ("**Do the Math: ESOPs Can Dramatically Increase Sellers' Proceeds**"), we outline an example ESOP transaction, which uses ordinary and reasonable transaction assumptions, and the result is that the selling shareholders net 50% higher proceeds under the ESOP transaction than under an outright sale of the company. Please see our website or contact us for a copy of this article.

Myth #2: The Employees Run the Company in an ESOP

Control of the day-to-day operations of a company is largely unrelated to ownership in an ESOP-owned company, as these factors are determined by a company's corporate bylaws and the ESOP plan documents. In fact, the corporate governance structure in an ESOP company is unchanged from a non-ESOP owned company: the shareholders (which include the ESOP) elect the Board of Directors, the Board of Directors hires management, and management runs the company. While it is true that ESOPs often thrive in companies with participative/open-book management cultures, this is certainly not a requirement and employees have no right to make management decisions or receive confidential information (such as financial statements, salary information, etc.) due to the existence of an ESOP. Additionally, business owners sometimes elect to sell ownership to the ESOP in stages as part of a planned business succession strategy rather than all at once, thus maintaining voting control of the business for the duration of the owner's tenure at the company.

Myth #3: ESOPs Only Work in Very Large Companies

Of the 6,000+ ESOPs in place in the United States, less than 10% of those are in publicly traded companies. The National Center for Employee Ownership reports that over half of ESOP companies have less than 100 employees. At GBQ, we work with ESOP companies of all sizes and in virtually all industries. The vast majority of our ESOP clients are "middle market" privately held companies, with 25 to 1,000 employees and annual revenues between $1 million and $1 billion, with an average of $5 to $100 million.

Myth #4: Company and Employee Performance Won't Improve with an ESOP

On the contrary, there are numerous studies that demonstrate how company performance improves with employee ownership through ESOPs due to the financial benefits of ESOPs as well as increased employee motivation and morale. The unique tax advantages of ESOPs (e.g., tax-deductible principal on ESOP debt, tax deductible ESOP dividends, the ability to create an income tax-free entity with a 100% ESOP-owned Scorporation, etc.) result in ESOP companies retaining more of the cash flow they generate, which can be used to reinvest in the company, make acquisitions, or other growth initiatives. In addition, an ESOP Association survey indicated that 63% of members experienced improvements in motivation and productivity as a result of the ESOP. 74% of ESOP companies reported stock price increases in the last year, and for nearly half of companies the increase was over 10%. Perhaps the most impressive statistic, however, is that 94% of ESOP companies report that creating their ESOP "was a good business decision that has helped the company."

Dispelling the Myths about ESOPs (continued)

Myth #5: ESOPs are too Expensive and Complex

The cost to maintain an ESOP is certainly not prohibitive or dissimilar to the costs to maintain other qualified retirement plans.

Of course, relative to doing nothing, ESOPs are expensive; however, relative to a traditional liquidity event such as a sale of a business, which often results in transaction fees of 3% to 6%, an ESOP transaction is typically much less expensive and much quicker to consummate. Transaction fees associated with an ESOP can vary widely depending on a number of factors (e.g., complexity and size of the transaction, professional advisors involved, etc.) and are extremely difficult to generalize or predict. Although we have been involved with ESOP transactions that generated total transaction fees of under $50,000 and over $1 million, various studies and sources, as well as our experience, suggest that average professional fees associated with ESOP transactions range from $100,000 to $300,000. The cost to maintain an ESOP will also vary depending on a number of factors, but is certainly not prohibitive or dissimilar to the costs to maintain other qualified retirement plans. ESOPs can appear to be complex, but if experienced ESOP advisors are assisting you with the transaction and the company is willing to commit to a communications plan to education management and employees about the ESOP, these complexities can be overcome. An ESOP transaction is oftentimes much less complex than a traditional transaction, as ESOP transactions can often be consummated in as few as 90 days.

Myth #6: ESOPs Place an Insurmountable Financial Burden on Companies

The key company characteristics necessary for an ESOP to work are: (a) strong and steady financial performance, (b) debt capacity, (c) solid management team, (d) stable employee base, and (e) a willingness to transition some or all of the ownership of the company.

The debt associated with a leveraged ESOP transaction is a corporate liability that must be repaid. As such, ESOPs should only be pursued by companies with debt capacity and the ability to repay the transaction loan. However, if the ESOP transaction and loan is structured appropriately (i.e., purchase price that is not higher than fair market value, reasonable interest rate, sufficient term, etc.), a company's cash flows should be adequate to satisfy the ESOP loan. An analysis to demonstrate the ability to repay the loan is an integral part of any ESOP feasibility assessment. The other financial burden created by an ESOP is the "repurchase obligation" of the company to buy shares held by employees who retire or leave the company. While it is true that the ESOP repurchase obligation is a significant liability, particularly for mature ESOPs, proper planning can almost always alleviate this issue. ESOP repurchase obligations are akin to other succession planning-type arrangements that exist at many companies, such as buy -sell agreements. ESOP repurchase studies can be performed to assess the magnitude and timing of future liabilities, and the ESOP plan document can be structured to ensure flexibility in satisfying this obligation (e.g., payouts over time, deferral until the ESOP loan is repaid, etc.). Ultimately, with proper planning and proper valuations, most ESOP companies should generate sufficient cash flow to satisfy the repurchase obligation and sustain the ESOP ownership structure indefinitely.

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Dispelling the Myths about ESOPs (continued)

Myth #7: ESOPs are too Good to be True

ESOPs are a savvy, underutilized, mutually-beneficial, and often misunderstood business succession planning strategy. The key company characteristics necessary for an ESOP to work are: (a) strong and steady financial performance, (b) debt capacity, (c) solid management team, (d) stable employee base, and (e) a willingness to transition some or all of the ownership of the company to the ESOP. If these characteristics are in place at your company, there is a great chance that an ESOP could work.

Conclusion

Although ESOPs are not the right fit for all companies, they can be a perfect and unique fit for many. To assess whether an ESOP makes sense for you and your company, the first step is typically to contact an ESOP advisor to perform an "ESOP feasibility analysis." GBQ and its professionals have extensive experience with ESOP consulting, implementation, and valuation, and we would be happy to consult with you and your advisors on a confidential basis about the merits of exploring an ESOP.

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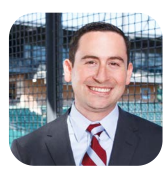

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