February 2017

A Healthy Transition: Why ESOPs Can Be a Good Fit for Social Services Companies

By Michael McGinley

Social services companies can be uniquely suited to be employee-owned companies, thereby creating a transition strategy for owners, providing retirement benefits for employees, and helping to ensure long-term business success.

An Employee Stock Ownership Plan ("ESOP") is a vehicle to transfer ownership of a company from an owner to a trust for the benefit of its employees. ESOPs are most commonly used as an ownership transition vehicle to provide liquidity for business owners using tax-deductible corporate funds. The employees benefit from this in that the value of these shares accumulate in their accounts for their retirement, which can be a valuable motivational tool to attract, retain and reward employees. Today, the National Center for Employee Ownership ("NCEO") estimates that there are about 7,000 ESOP companies nationwide and that approximately 28 million employees participate in some form of broad-based employee equity ownership.

ESOPs are becoming more popular in the social services industry as awareness of the benefits of these types of plans grows. According to the National Center for Employee Ownership, there are more than 150 healthcare/social services companies with ESOPs, representing approximately 200,000 participants with total plan assets of approximately $6.4 billion. With increased awareness, it is anticipated that more companies will turn to this succession planning strategy offering a win-win for owners and employees.

Why ESOPs May Be Right for Social Services Companies

An ESOP can be an attractive ownership transition strategy for social services companies for several reasons, including preserving owner legacy; attracting and retaining loyal employees; favorable state laws; and a robust financial market for leveraged ESOPs, with a near-zero default rate for investments. Following is an example of how Prairie Capital Advisors ("Prairie") helped one company in this industry become an ESOP.

The Cornerstone / Liberty ESOP Stories

Prairie recently served as the sell-side advisor for the implementation of an ESOP plan for Cornerstone Treatment Facilities Network in New York. One of the leading addiction treatment centers in the U.S., it was founded by entrepreneur Norman Sokolow more than 40 years ago.

When Prairie was hired to help Cornerstone develop an ownership plan, the team had the opportunity to learn more about Cornerstone and how they do business. As part of the transaction process with Cornerstone, the Prairie team spent time at their facilities, visiting patient rooms and seeing the faces of the people Cornerstone helps every day. Through this process, Prairie learned that an important aspect of the Cornerstone culture is a very patient care driven culture. For example, the staff spends more time with patients and admits fewer individuals per room than is required by Medicaid, a factor employees believe has contributed to Cornerstone's long-term success and more successful patient outcomes. This type of decision can be hard, especially as the company experiences nearly 100% occupancy rates in its treatment facilities.

When Cornerstone's shareholders decided it was time to put in place a plan for ownership transition, they considered a few options: sell to a strategic buyer such as a big conglomerate or private equity firm, sell to an internal buyer such as the management team, or opt for an ESOP.

Selling to a strategic buyer turned out to be difficult because of regulatory issues. Most of Cornerstone's funding comes from Medicaid and the business is governed by the New York State Department of Health as a chartered hospital. Cornerstone is also regulated by the state Office of Alcoholism and Substance Abuse Services. Any buyer of the business would have to pass a rigorous character and competency review, which would exclude most out of state potential buyers.

A management buyout was also considered but financial constraints precluded this type of transaction.

Ultimately, the shareholders decided that an ESOP was the best choice for Cornerstone. From the company's perspective, an ESOP would allow its employees to benefit from owning shares in the business. Additionally, by keeping the company ownership with the employees, this ownership transition option should best help preserve the legacy and culture established by the company. From a financial point of view, the price the shareholders received for their shares of the company was in line with that of a market based sale, creating a win/win scenario for both sellers and employees going forward. Finally, from a lending vantage point, the sellers were able to receive substantial liquidity at closing because the tax benefits of being a 100 percent employee owned S-corporation provided ample cash flow coverage for the outside debt incurred in the transaction.

In the end, an ESOP was the best choice for both the sellers and employees of Cornerstone.

As good news travels fast, another firm in the same industry in New York learned of Cornerstone's ESOP and decided that the owners of that firm would like to pursue an ESOP as well. A few months after Cornerstone was sold to an ESOP, the owners of Liberty Behavioral Management Group, Inc., which owns and operates two large inpatient Substance Use Disorder ("SUD") facilities and leases and operates ten SUD licensed outpatient clinics throughout New York State, also was sold to an ESOP.

Finding a Financial Advisory Firm with ESOP Experience

ESOPs can be a highly effective tool for ownership transition with many advantages for business owners, including tax, financial and cultural benefits.

When considering an ESOP, one of the first things to do is seek a financial advisory firm with ESOP experience. While other firms may be qualified to handle certain financial transactions, a financial advisory firm with ESOP expertise understands the unique requirements and nuances necessary to ensure the successful implementation of an ESOP. Look for an ESOP financial advisory firm that has strong relationships with other well-respected ESOP professionals like attorneys, CPAs and fiduciaries, and has presented on ESOP topics at industry meetings like NCEO and The ESOP Association.

Future of ESOPs for the Social Services Industry

The future of ESOPs for the social services industry looks promising. From preserving the owner's legacy to rewarding and retaining management and staff with employee ownership, ESOPs can be an attractive strategy to ensure long-term company success. Other benefits such as tax advantages and opportunities to diversify assets also make ESOPs appealing for ownership transition.

As the industry grows and financial markets continue to be robust, ESOPs can be an effective transition solution for social services company owners and employees.

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