

ESOP Structuring & Financing: Anticipating & Avoiding Obstacles

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Overview

Do ESOP transactions ever fail to close? Absolutely. ESOP transactions are not that dissimilar to M&A transactions in that both transaction types may stall as a result of various issues, including valuation gaps between the buyer and seller, the inability to obtain desired financing and other external factors. Still, the obstacles that arise during the structuring and negotiating of an ESOP transaction are generally not insurmountable. With the guidance of experienced ESOP professionals, most concerns can be resolved or avoided through proper planning and communication. Anticipating the common obstacles that arise during the structuring and financing of an ESOP transaction eliminates surprises and invariably smooths the process while saving transaction expenses.

Lender Obstacles

A prospective ESOP company's inability to secure financing for a leveraged ESOP is probably the most difficult obstacle to overcome. The inability to secure financing usually results from desires that are unrealistic relative to the capital markets, generally due to one or more of the following:

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- High existing leverage
 - Limited debt capacity that restricts a company's flexibility, often arising from:
 - Inconsistent historical operating cash flows
 - Insufficient cash flows to service debt obligations
 - Projected cash flows that rely on future performance that reflects unprecedented or unsupported increases in sales, increases in margins, etc. – the “Hockey Stick”
 - Insufficient assets (for example, as may occur with a service company) to secure the ESOP loan obligation, or asset appraisals well below the owner's expectations
 - Lack of mezzanine financing on terms appropriate to the ESOP
 - Lack of seller support via a note take-back or guarantee

An important step that a prospective ESOP company can take to avoid financing obstacles is to consult with its financial advisor and prospective lenders while the transaction is still in the conceptual stage. A realistic assessment of the ability of the company's cash flows to service the proposed ESOP debt is critical. Senior lenders will look for a primary (cash flow) and secondary exit (assets or guarantees). While the strength of asset support may mitigate temporary weakness in the cash flows, it is stable, predictable cash flow that repays loans.

Collateral shortfalls can be anticipated at the outset to determine whether the guarantee of a selling shareholder, the pledge of sellers' qualified replacement securities, external junior capital or a reduction in leverage should be proposed.

Prudent preplanning by a prospective ESOP company should include a realistic assessment of the value of the company's collateral. Appraisals of equipment and real estate should be considered at the preplanning stages, especially if the prospective ESOP company does not have a good idea of current value, as appraisals likely will be required by a prospective ESOP lender before the closing of financing.

In the event of a collateral shortfall, the pledge of a selling shareholder's proceeds (potentially “1042 qualified replacement securities”) in support of his/her guarantee can provide a lender with an attractive collateral alternative while maintaining seller tax benefits. Under Internal Revenue Code Section 1042, an owner of a closely-held C-Corporation can indefinitely postpone federal capital gains taxation on the proceeds of a sale to an ESOP that owns

30% or more of the company after the sale if such proceeds are reinvested in “qualified replacement securities” (i.e. securities of U.S. operating companies) and certain procedural requirements are met.

In the planning stages, one should consult with a senior lender. With strong, stable, predictable cash flows and rapid de-leveraging, a senior lender may consider a collateral shortfall of defined magnitude and predictable duration.

Given the flexibility and tax efficiency of ESOPs, a common component of financing for a 100% ESOP transaction takes the form of a deeply subordinated seller note that makes up the difference between senior financing and the aggregate capital need. Sellers often do not mind taking a note in order to help fund the transaction, as doing so allows them to not only benefit from a subordinated debt return on an investment that they know intimately, but it may also give them the ability to enjoy any upside in the business in the form of detachable warrants. The all-in returns for the selling shareholder are similar to what an outside subordinated lender would require.

Many of the financing obstacles outlined above can be avoided through somewhat more creative capitalization of the proposed ESOP transaction. While a combination of senior financing and seller notes are typically relied upon to complete the ESOP transaction, one may also look to a capital structure that includes either traditional mezzanine financing or equity financing from third party investors, thereby providing additional cash to the seller at closing and satisfying the senior lender. Today, there are ESOP-specific mezzanine funds and private equity funds which invest in ESOP buyout transactions. Using mezzanine financing and equity financing creates equity dilution obstacles for the ESOP trustee; however, these capital sources can be used to close some of the most complicated transactions.

Finally, a very simple and popular structuring idea used to increase a company’s ability to finance an ESOP is to adopt a staged transaction approach, whereby the ESOP will buy a certain percentage today with the intention of purchasing additional shares at a later point in time. The flexibility of structuring ESOPs in this manner allows the selling shareholder to diversify his/her wealth by selling to the ESOP in stages versus selling the company all at once and ultimately accomplishing the transition goal.

The ESOP is a unique buyer in its willingness to take a minority equity stake in a privately-held business.

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Valuation Obstacles

The “valuation gap” is just as prevalent in ESOP transactions as it is in traditional M&A transactions. Valuation issues are difficult and sensitive matters to negotiate in any transaction and, in fact, may appear more difficult to successfully negotiate in an ESOP deal. An ESOP is prohibited by the Employee Retirement Income Security Act of 1974 (“ERISA”) from paying more than the fair market value for company stock, as determined by an independent appraiser. For closely-held stock, fair market value is the price at which the stock would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts.

While an independent buyer, given synergistic benefits associated with merging operations or cutting expenses, may be willing to pay more for a given company than an ESOP, ESOPs are prohibited from paying a “premium.” Seller(s) may initially be turned off by the thought of receiving a potentially lower gross price from an ESOP versus what they would receive in a sale to a competitor. However, given the fact that the seller(s) may choose to elect 1042, that ESOP transactions are stock deals versus assets deals (as most private M&A transaction are) and the upside potential of warrants associated with seller financing, the net benefit to the seller(s) in an ESOP transaction is often on par with or better than that of other types of transactions. An experienced ESOP investment banker will help the seller(s) understand these differences early on in the process.

As the ESOP and the private equity buyer are dependent on the same stand-alone cash flows for valuation and debt service, the economics of the ESOP transaction can compare quite favorably to the private equity sale.

Finally, consider that valuation is often measured in terms beyond simple dollars and cents. Given near-comparable economics, many sellers highly value the ability to remain active and influential in the company post-transaction, to offer their employees an opportunity to benefit from ownership and to continue the legacy of the company that they may have created.

Trustee Obstacles

In the interest of saving money, companies may consider appointing an employee as the trustee of the company’s ESOP rather than hiring an institutional trustee to complete the transaction. This situation presents a number of potential problems. An ESOP trustee owes a fiduciary duty to the

plan participants to act solely in their best interest, even if it is not in his/her own best interest. Furthermore, an ESOP trustee is personally liable to each of the plan participants for any breach of this fiduciary duty.

In negotiating the purchase of shares for the ESOP, an internal ESOP trustee is put in the uncomfortable position of having to negotiate the best price for the plan participants against the owner of the business. Often, an employee acting as the internal trustee feels respect for and loyalty to the owner, and may therefore find it difficult to negotiate objectively on behalf of plan participants. This can lead the internal trustee to seek a compromise that benefits the seller and is detrimental to the ESOP participants.

Further, some internal trustees have the mistaken belief that simply purchasing the ESOP shares at a price set forth in a valuation report relieves them of all fiduciary liability. In fact, the ESOP trustee (internal or institutional) must conduct an independent investigation of the company as well as a thorough investigation of the valuation report and the methods used by the valuation firm in rendering its opinion of the value of the company. Failure to make this independent investigation can subject the internal ESOP trustee to personal liability in the event of a lawsuit by plan participants. These duties and responsibilities continue with the internal trustee in subsequent annual valuation updates, the administration of the plan, etc.

While internal trustees may be briefly considered for the initial transaction, the majority of today's new ESOP transactions are completed with an independent institutional trustee negotiating the ESOP purchase as an arms-length transaction occurring at not more than fair market value and structured fairly for the employee beneficiaries.

As mentioned, the ESOP trustee must conduct thorough due diligence to support its negotiation of a fair transaction and in support of subsequent annual valuation updates. It is also critical that the trustee document its processes, procedures and assumptions as reasonable at the time of the transaction.

Moreover, prudent ESOP lenders look closely at the ESOP trustee underwriting the loan. Most ESOP lenders require an institutional trustee for transactions that they finance. An institutional trustee traditionally completes extensive due diligence before entering into the transaction and scrutinizes the valuation report with a critical eye. This provides the lender with a level of comfort that a thorough analysis has been conducted.

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As in any M&A transaction, it is important to avoid surprises. An experienced ESOP advisor will assist the company in preparing the information necessary for the trustee to complete its diligence and asking the right questions to avoid surprises in the trustee's due diligence.

Given the ongoing responsibilities of the trustee, the company often weighs the economics and merits of employing the independent external trustee on a continuing basis or perhaps utilizing an internal trustee for the less burdensome post-transaction duties. While liability and potential conflict issues remain, an internal trustee can accomplish the same level of diligence, provided that the trustee is represented by independent financial and legal advisors to aid in fulfilling his/her fiduciary duties on an ongoing/annual basis.

Conclusion

Obstacles can develop in any transaction involving the sale of a company's assets or stock. In particular, ESOP transactions present unique and interesting challenges. However, experienced ESOP professionals can assist in providing creative ways to eliminate obstacles to closing a deal in nearly every situation.

About Prairie Capital Advisors

Prairie Capital Advisors offers investment banking, ESOP advisory, valuation advisory and financial reporting valuations to support the growth and ownership transition strategies of middle-market companies. Headquartered in Oakbrook Terrace, Illinois, the company is a leading advisor to closely-held companies nationwide. For more information, call 630.413.5574 or visit www.prairiecap.com.

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