

# Structuring an ESOP Transaction

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November 2017

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## Overview

For many privately-held business owners, the sale of their company is a once-in-a-lifetime event. Faced with this inevitable decision, you want to make the right choice. This can be a confusing and emotional undertaking. After all, you have lived and breathed this business for a considerable portion of your life. Like one of your children, you want your business to grow and prosper long after your departure.

There is a point of self-reflection when the owner decides the primary motivator for transitioning the business, other than retirement of course. While price is important, it is not the only motivating factor. Thoughts such as company legacy, employee welfare and local community may be important factors. These qualitative factors can be an excellent setting for an Employee Stock Ownership Plan (“ESOP”).

At the surface, the ESOP is merely a qualified retirement plan; however, it possesses other unique characteristics that make it an attractive option to someone seeking liquidity from their business.

ESOP Benefits
Short implementation time vs. full sale process
Flexibility—full or partial liquidity
Employees participate in company success
<b>Tax Benefits</b> Debt repaid with pre-tax dollars 1042 capital gains deferral ESOP earnings are tax exempt Tax deferred ESOP account growth

Structuring an ESOP will take careful consideration during the implementation process so the resulting transaction will lead to strong value creation for the employees, the company and the seller.

## Transition Begins with Valuation

Valuation serves as the foundational building block of the entire transaction. If the valuation is below the seller's expectations, the seller may then search for a suitable alternative for seeking liquidity. Having a preliminary valuation completed early in the process can save significant time and resources if the seller's expectation cannot be attained.

The business owner should engage an experienced financial advisory firm to conduct a preliminary valuation. Every business is unique; the advisory firm should have an understanding of the company's history, historical performance, future performance, products/services, customer base, economic conditions, industry conditions and trends, strategic objectives and other important elements. The advisory firm solidifies this understanding by conducting detailed due diligence. The valuation is a great opportunity to learn what factors positively or negatively impact the value of the company. In many cases, companies that do not create long-term budgets utilize the valuation as a basis for strategic planning. Valuation is often laden with assumptions and differences of opinion, so it is necessary to ensure the value is based on real data and accurate

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projections—not on emotions. The valuation should follow commonly-used income-based and market-based methods such as the discounted cash flow method, guideline public company method and guideline transaction method. Asset-based methods can also be utilized, but that is reserved primarily for liquidation settings or companies that have unique asset bases (i.e. “REITs”). Once the valuation analysis is complete, the advisory firm will communicate a range of values that may be appropriate for an ESOP transaction.

## ESOP Transaction Basics

An ESOP transaction is an “arm’s length transaction,” and the valuation needs to adhere to the fair market value definition. Fair market value is defined as “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, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for such asset.” Do not confuse or overlook the fact that the ESOP is a third-party buyer.

Before the transaction takes place and once an ESOP plan is adopted, a Trustee is appointed to manage the assets of the trust. The ESOP Trustee can be **internal**, meaning an individual or group of individuals employed by the company, typically a member or members of management. The ESOP Trustee can also be **external**, meaning a person outside the company or an institution hired to act in the ESOP Trustee capacity. The ESOP Trustee is the legal shareholder of the ESOP shares and is an ERISA Fiduciary whose primary role is to act in the sole interest of the ESOP plan participants. The Board of Directors is responsible for appointing the ESOP Trustee; however, as a shareholder, the ESOP Trustee can vote the ESOP shares to select the Board of Directors. It is highly recommended to engage an external ESOP Trustee during the transaction process. The external ESOP Trustee will eliminate potential conflicts of interest between the buyer and seller, in addition to ensuring there are proper procedures and documentation during the transaction process.

The ESOP Trustee is going to be faced with an important investment decision during the transaction process—how much should the ESOP pay to acquire the owner’s stock? Since the ESOP is an ERISA-protected retirement plan, the ESOP **cannot** pay more than fair market value. The ESOP is known as a “financial buyer” opposed to a “strategic buyer.” A financial buyer is making the purchase based purely on the expectation of future investment returns, much like the investing public. Strategic buyers are typically competitors, suppliers or customers of the company that are looking for synergies between

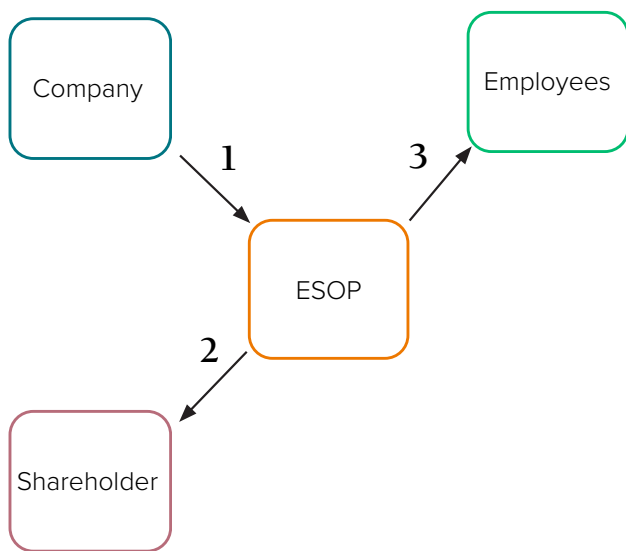
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the two firms. Since the strategic buyer can directly affect the operations of the business, the valuation for these transactions can far exceed that of a financial buyer. As such, the ESOP does not bring any synergistic benefits to the company and thus **cannot** pay a strategic price.

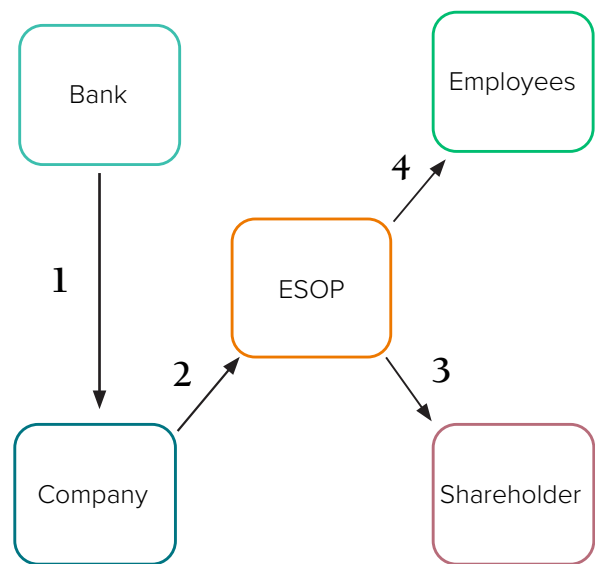
The ESOP Trustee must engage an independent financial advisor to advise the ESOP Trustee on the fair market value of the stock being purchased. Additionally, the ESOP Trustee will request that their financial advisor issue a fairness opinion for the transaction. The ESOP Trustee's financial advisor does not work for the company or selling shareholder. Often times, the business owner will engage a separate financial advisor to represent the seller and the Company.

## Un-Leveraged ESOP Structure



1. Company makes annual tax-deductible contributions in cash or stock to the ESOP.
2. Cash is used to purchase stock from shareholder.
3. Shares are allocated to employee accounts based on W-2.

## Leveraged ESOP Structure



1. Bank loans proceeds to the company ("outside" loan).
2. Company loans proceeds to ESOP ("inside" loan).
3. ESOP buys shares using proceeds of the "inside" loan and the ESOP holds purchased shares in suspense.
4. Each year the company makes a contribution to the ESOP → Shares are allocated to employees → ESOP takes contribution and repays "inside" loan to the company → Company takes "inside" loan payment and repays "outside loan."

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## ESOP Transaction Structure

The structure of the ESOP transaction should be custom-tailored to meet the needs of the selling shareholder and other stakeholders. There are two primary types of transaction structures: un-leveraged and leveraged. In the un-leveraged scenario, the Company will create and adopt the ESOP plan and trust. However, there needs to be a mechanism which allows the ESOP to hold the company stock. The company may contribute stock directly into the trust, which is then allocated to employee accounts based on compensation levels. The company can also fund the ESOP with cash, which is then used to purchase stock from the selling shareholder or corporate treasury. Under each scenario, the Company will receive a tax deduction for the either the amount of the cash contribution or the fair market value of the shares contributed.

The leveraged ESOP is the most common structure for ESOP transactions. One of the biggest differentiators between ESOPs and other qualified retirement plans is that the ESOP can borrow money. Under the leveraged scenario, the sponsoring company borrows money from a bank or lending institution. The Company loans the proceeds to the ESOP Trust who, in turn, purchases the stock from the selling shareholder. There are two loans that take place during the transaction process: (1) the **outside** bank loan between the sponsoring company and the bank and (2) the **inside** loan between the company and the ESOP Trust. The purchased stock is held within a suspense account as collateral for the inside loan. Employees receive stock allocations as the Company makes annual contributions to the ESOP Trust. The sole purpose of the inside loan is to allocate the stock to the employees over a specified period of time. There is no requirement that the inside loan and outside loan have the same amortization schedule. The length of the inside loan can vary up to 30 years based on the amount of benefit the company wants to deliver.

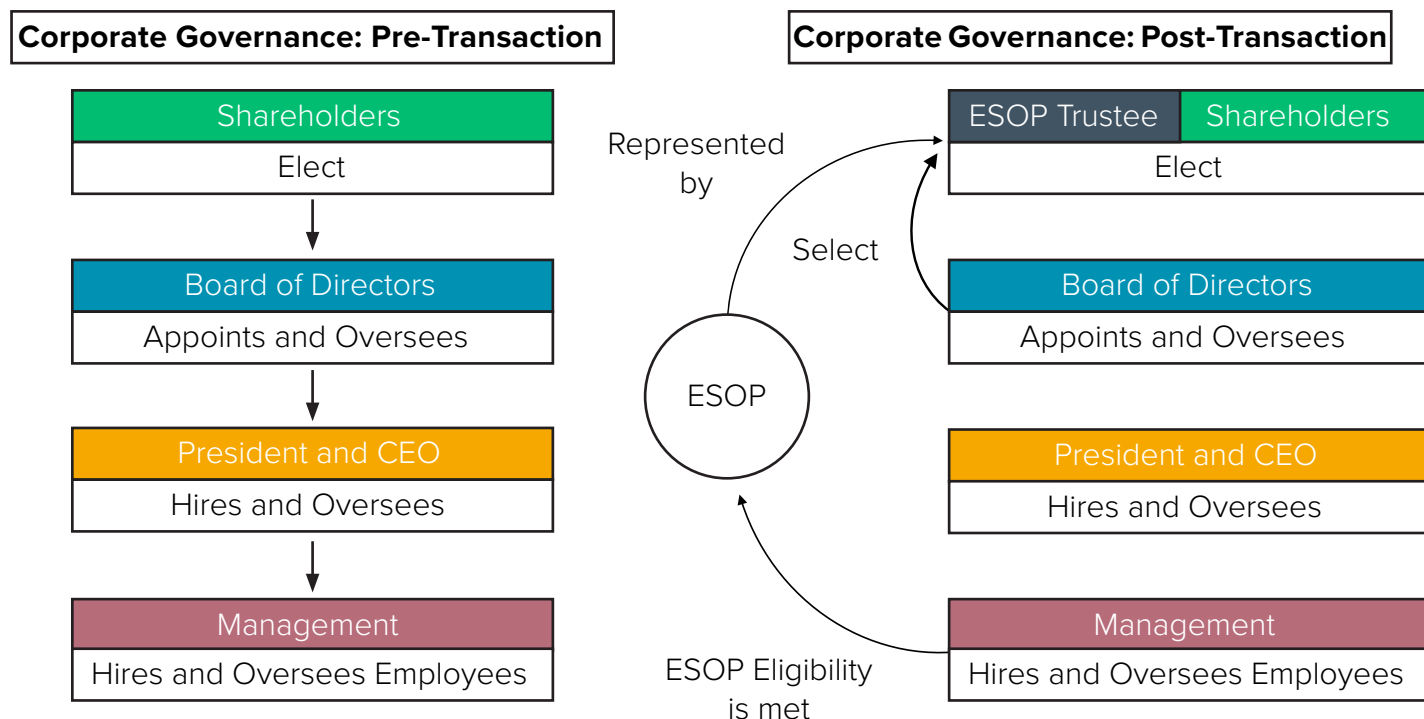
## Pre-Transaction Considerations

**Corporate Governance:** It is crucial to understand how the transition to an ESOP-owned company will affect the operations of the business. Once the ESOP purchases shares of the company, a new shareholder has been created. In some cases, it is often misunderstood that the ESOP is, in fact, a legal shareholder; after all, it's not a person. However, the ESOP's interests should be acknowledged and addressed. The company should begin to look/act like a mini-public company. In many cases, companies will increase the size of the board by adding outside directors. Since the owner will be responsible for more than himself/herself, it is important to lay the foundation

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for management succession. External directors can be highly effective value drivers. They challenge the status quo and bring outside experience and advice to an otherwise unchanged management philosophy. External directors will hold individuals accountable on important factors such as sustainability, strategy, execution and company performance. A change in corporate governance should not be viewed as a negative because there is a direct correlation between successful ESOP companies and strong corporate governance practices.



**ESOP Benefit Profile:** Having goals and purpose for the ESOP will result in a more effective plan design and will ultimately benefit the sponsoring company and employees. What level of benefit should be provided to the employees? The benefit profile will ultimately be decided by the size and term of the inside loan between the ESOP and the Company. During the feasibility study, the financial advisor will be able to communicate how much benefit the proposed transaction will deliver to the employees. Depending on the results of the analysis, the size of the benefit can be altered to meet the goals of the sponsoring company. For example, if we assume the ESOP purchases \$1,000,000 of stock and the inside loan is proposed to have a 10-year amortization schedule, the ESOP essentially “prepaid” a \$1,000,000

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benefit to be delivered over a 10-year period. So, each year, 1/10th or \$100,000 will be allocated to employees based on W-2 compensation. The \$100,000 allocation will translate to a benefit level of (x) percent of qualified payroll. The Company can alter the benefit level by negotiating the length of the inside loan. A shorter loan will allocate more stock over a shorter duration, resulting in an increased benefit profile. A longer inside loan will allocate less stock over a longer duration, resulting in a reduced benefit profile. By having an understanding of the benefit profile, the company is able to custom-tailor the ESOP plan to meet any compensation guidelines or goals.

## What is a Feasibility Study?

Once it is decided that the ESOP path is worth pursuing, it is imperative to have a feasibility study completed. The feasibility study serves as decision-making tool that measures the impact the transaction will have on all parties involved. The study combines different analyses that cover the many areas of concern encountered during the transaction process. The greatest benefit of the feasibility study is that multiple scenarios and transaction structures can be created to assist the selling shareholder and other stakeholders in achieving the desired end goal.

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## Understanding the Impacts of the Transaction

The feasibility analysis will commence once the financial advisor has formed a suitable fair market value range for the company. At this point, the financial advisor will determine, along with the selling shareholder, the size of the transaction. Is the seller looking for full or partial liquidity? It is good practice to analyze different transaction sizes in order to gauge the economic impacts. You may find out that it will take multiple transactions over a series of years to accomplish the end goal.

In order to avoid any potential financing obstacles, the company should approach its prospective lender(s) early in the process. This way, any potential shortfalls, an important one being collateral issues, will be known. If the bank is aware of these issues early on, solutions can be proposed without significant delays to the transaction timeline. There are several lending sources, such as local community banks to large national institutions, that will finance a portion of the transaction. Larger institutions may have specialized lending groups that understand the technical nuances of ESOPs. There are other financing sources, such as mezzanine debt and subordinated debt, that will provide additional cash liquidity, but these financing arrangements can be quite expensive. If cash at close is not a motivating factor, the seller may “act as” the bank and seller finance the transaction. Seller financing can provide an income stream that has a market level return for a subordinated debt instrument that would otherwise be difficult to replicate in the debt and equity markets. Depending on the size of the transaction, traditional bank financing may be all that is required, or it may end up being a mix of different financing sources to fund the transaction.

A critical step in the feasibility study is considering the cash flow impacts of the transaction. Difficultly servicing transaction debt should raise a number of red flags regarding the transaction structure. The transaction size may be too large, or the terms of the debt service may be aggressive; whatever the reason, the cash flow analysis will identify what is causing the issue. From there, the financial advisor can recommend changes to the structure to overcome the obstacles. Keep in mind that the leverage utilized to fund the transaction is “non-productive,” meaning that it is not utilized to buy equipment or build a new facility. The feasibility analysis will identify the tipping point between holding productive and non-productive debt, so there is no disruption to the future operations of the company.



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## What Should You Know After the Feasibility Study?

*What is the size and potential value of the transaction?*

*How is the transaction financed?*

*Can the company service the transaction debt?*

*Can strategic objectives be met on a post-deal basis?*

*Does the ESOP meet the company's employee benefit goals?*

*What does the ESOP mean to the employee base?*

*What are the potential returns to equity and debt holders?*

*Can the company "weather" an adverse operating environment?*

*What are the impacts to management incentive programs?*

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Additionally, the financial advisor should create a series of scenarios that "stress test" the transaction.

Once financing arrangements have been determined, the next step is to overlay the transaction effects (principal and interest, fees and ESOP contributions) on the company's future cash flows. The financial advisor should utilize the same projections that were developed during the valuation process. At this point, you are able to illustrate the impact the transaction has on the cash flows and operations of the company. Additionally, the financial advisor should create a series of scenarios that "stress test" the transaction. The financial advisor will typically create at minimum three scenarios: (1) Base Case, (2) Aggressive Case and (3) Conservative Case. Each of these cases will have differing levels of revenue growth and margin levels, with the transaction size and terms held static.

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## **Common Stress Test Variables**

**Revenue Growth**

**Gross Margin and Operating Expense Changes**

**Capital Expenditures**

**Working Capital Requirements**

**Financing Changes (Terms & Mix - Senior v. Seller)**

**ESOP Benefit Level Changes**

The goal of the stress test is to demonstrate how the company would perform under various operating environments. What would happen if another recession were to occur? Can the transaction debt be serviced if revenue was flat or margins were to erode? If the company goes through an aggressive growth phase, will they have the ability to fund excess capital expenditures? Knowing the company will be able to “weather” another storm or handle an unexpected growth phase will give the seller and ESOP Trustee comfort that transaction is not overly aggressive. However, based on the findings, this may result in altering the transaction structure and terms to avoid any possible issues with solvency or liquidity.

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## Summary

Once the feasibility is completed, it should be presented to the ESOP Trustee. At this point, any questions or concerns can be addressed, and alternatives may be discussed. The feasibility study will serve as the structural blueprint for the transaction. Once all of the areas of concern have been addressed, negotiations between the ESOP Trustee and selling shareholder should begin. Typically, the seller will submit a term sheet outlining the deal terms and conditions to the ESOP Trustee. Along with its legal counsel and financial advisor, the ESOP Trustee will analyze the deal terms and either accept or propose a counter offer. Negotiations may go through multiple iterations before the deal terms and conditions are ultimately accepted by both parties. Once the terms and conditions are agreed upon, the next phase involves funding preparation, legal documentation and moving to close the transaction.

Structuring an ESOP transaction is a balancing act for a number of constituencies. The seller may be fixated on a valuation multiple or cash liquidity. Management of the company needs to make sure it can still operate and meet its strategic initiatives after the transaction. The ESOP Trustee will be concerned with the employee benefit profile, fairness, corporate governance and any value detractors built in the structure (i.e. stock appreciation rights, management incentive programs, etc.). The most successful ESOP transactions are structured with the best interests of all stakeholders in mind.

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### 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](http://www.prairiecap.com).

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