EMPLOYEE STOCK OWNERSHIP PLANS
CANDIDATE COMPANY CHARACTERISTICS

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Overview

While certainly not the only reason, there is one compelling market demographic that is likely fueling the comeback of Employee Stock Ownership Plans ("ESOPs") in America today, and that is the aging population of so many successful business owners. According to a recent study by the General Accounting Office, over the next fifteen years an estimated $7 trillion to $12 trillion in wealth transfer will take place, and the federal estate tax liability associated with this transfer of wealth is significant, and some would even say staggering. Though not easy to accurately quantify, a meaningful component of this older generation wealth is attributable to ownership in privately held businesses.

Due to the above and other factors, ESOPs are currently undergoing a revival as the total number of ESOPs has increased to about 10,000 in just the last several years. It is estimated that there are now over 11 million ESOP participants in the U.S. workforce.

Some tax and estate advisors are considering ESOPs in conjunction with estate and succession planning for their private business owner clients. By their nature, closely-held businesses are considered an illiquid asset, and selling the business to the employees is often a viable way to not only provide some level of liquidity to the owner, but to also establish a definable value for the business in conjunction with a comprehensive estate and tax plan.

Many successful businesses are using ESOPs as a way to retain and compensate employees, and to instill an ownership culture throughout the company. Some business owners have an altruistic motivation to pass the company on to their employees, often as recognition for their having contributed to the company's ongoing success. However, for certain business owners an ESOP may be the only viable exit strategy available.

Sheldrick, McGehee & Kohler, LLC ("SMK") has been involved with Employee Stock Ownership Plans since the late 1970s, and has represented as financial advisors over 200 ESOP companies during that period. Currently we represent approximately eighty employee ownership plans, and are one of the largest ESOP appraisal firms on the East Coast according to the ESOP Association in Washington, DC.

As a rule, ESOPs are not well understood by most business owners, and many business advisors. The name itself is misleading, as it tends to insinuate that employees are becoming co-equal shareholders, which they typically are not. Consequently, ESOPs are often overlooked in situations where they may not only be appropriate, but could be one of the few viable solutions for a company exploring business succession strategies.

For many privately held businesses, the properly structured, tax-sheltered ESOP is a very efficient and convenient way to sell a majority or minority interest in the company. In addition, an ESOP is the only leveraged transactional structure where both principal and interest payments are made with pre-tax dollars. The ESOP concept can also be an excellent 'stalking horse' when negotiating the sale of a business, as a prospective buyer will have to compete with the beneficial tax advantages of the ESOP transaction.

This paper provides some insight into ESOPs, discusses the inherent company characteristics that make the implementation of an ESOP feasible, and helps to identify certain ESOP issues or pitfalls that prospective ESOP companies should typically try to avoid. All of the various ESOP characteristics and components (i.e. tax advantages, employee ownership, management transition, leverage, implementation and ongoing costs, etc.) should be carefully considered before making a final decision to move forward.

ESOP Advisory Team

To start, it is our view that ESOPs should be tailored to meet specific shareholder and corporate objectives. To do this, the successful ESOP requires the coordination of many disparate disciplines: employee benefit law; compensation strategies for key executives including buy-sell agreements, key-man, and other forms of insurance; business valuation; corporate finance; just to name a few. In addition to the aforementioned, this is also an opportune time to review and/or implement a comprehensive tax and estate plan for both the selling shareholders, and the company's senior management team. It is rare that all of these different specialties and products are available through a single professional service provider, thus a successfully implemented ESOP will generally require a strong, interdisciplinary team of advisors. Often SMK will act as a conduit on the front end of the transaction to help bring together team members and coordinate the process.

As part of the valuation process, there are numerous issues unique to ESOPs which require resolution: Is the ESOP acquiring a minority or majority ownership interest in the company? Will a minority interest discount be applied to the stock value being purchased? If leveraged, what will be the impact of ESOP debt on the corporate financial statements, and stock value? How does the valuation impact the plan's long-term repurchase liability (i.e. buying back stock from retiring employees)?

From our exposure to many potential ESOP situations, we have identified a checklist of characteristics that we feel are important for a good ESOP candidate. Although these characteristics are not officially promulgated by the Department of Labor, the IRS or enumerated in ERISA, they are, in our view, important key indicators in assessing whether or not your business client is a good ESOP candidate.

Profile of an ESOP Owner/Seller

The owner profile of a good ESOP candidate would be the following:

1. A principal and/or shareholders who have a sincere desire to sell the business to their employees and are committed to supporting the ownership transition, particularly at the beginning of the process.
2. A willingness to accept a professional, independently established valuation of the company.
3. If not already in place, a commitment to train or recruit a high quality senior management team that will transition over time into a new leadership role within the company. During this period the selling shareholder can continue as the CEO and/or President, ESOP Trustee, company advisor, etc.

In many instances an ESOP is not the preferred structure if the owner is attempting to receive immediate, maximum value for the sale of a business. In addition, the ESOP Trust (a qualified retirement plan that actually owns the shares for the benefit of the employees) is rarely funded to the extent that it can pay cash up front for the total purchase price. Typically these transactions are either structured as an installment sale with owner financing, or through third-party borrowing (bank, brokerage firm, insurance company, etc.). However, with an ESOP all <u>principal</u> and <u>interest</u> payments will be tax-deductible to the company as contributions to the plan.

Characteristics of an ESOP Candidate Company

The combination of the ESOP's unique ability to buy out an owner with tax-deductible dollars (whether borrowed or seller financed), the previously discussed older age demographics of many private business owners, and the current low level of interest rates have collectively provided an advantageous environment for business owners to consider ESOPs. Below is an itemized list of certain of these characteristics which we believe will be useful to you in helping to identify good ESOP candidates:

Company Size & Profitability

Size in revenues is not easily defined. Professional service companies such as engineering and architectural firms may have relatively low revenue streams ($1,000,000 - $5,000,000), but often generate consistent and sizeable profits. Staff size also counts in that there must be enough structure in the company for it to have an active upper-management team, and preferably viable second-tier management rising through the ranks.

The company must have enough payroll to be able to fund sufficient pre-tax contributions for share purchases or to cover leveraged debt. Ideally, the company should also be recognized in its industry group and/or geographic market niche. Appropriate size is a function of the type of business, the company's product or service, and the company's market presence.

With the current payroll-based contribution limit at 25% of eligible compensation (typically W-2 income, with or without bonuses), a profitable company with payroll of about $1,000,000 could fund up to a $250,000 annual deductible contribution to an ESOP. This contribution could be used to service debt, purchase new shares, or both. We do have clients with smaller payrolls, but they are the exception, not the rule.

As indicated above, a candidate company must generate sufficient profits to be able to designate some portion to fund plan contributions in order to make ESOP share purchases and/or to service leveraged debt payments to a lender. In the case of a leveraged ESOP, banks or other lenders will typically only allow a portion of adjusted pre-tax profits to be used when determining an appropriate debt repayment schedule, presuming that there should be a "cushion" in the historic profit stream in the event of unexpected downturns, unforeseen capital expenditures, etc. Consequently, we rarely encounter a viable ESOP candidate company that does not have a minimum of $400,000 to $500,000 in consistently generated pre-tax profits. However, in determining this profit threshold number there will often be add-backs to more accurately reflect professional level compensation, adjustments for unusual or one-time bonuses, and other revenue and/or expense elimination modifications that are commonly required when recasting the forward-looking financial statement for privately held businesses.

Management

There should be active and responsible upper-management, either incoming or preferably already in place. By active we mean currently involved in making important and ongoing corporate decisions relative to financing, marketing, and product or service pricing levels.

It is critical that the candidate company be able to demonstrate that it is professionally managed, and not a "key-man" organization serving only the interests of a controlling shareholder. An ideal ESOP company will also have in place a program to promote or groom senior management personnel from within the company. If not, a management team must be brought in and trained for operating continuity.

Marketplace and Market Outlook

As previously discussed, the candidate company should be recognized within its own geographic market by commanding a discernable percentage of its market (market share) in order to minimize its vulnerability to competition and business cycles. For example, the smallest heating and air conditioning firm in the Orlando, Florida market may not be able to withstand an economic downturn despite the attractiveness of the overall marketplace. Conversely, a large, well-capitalized heating and air conditioning firm in a flat or mature market such as Charleston, West Virginia might easily have the financial wherewithal to withstand a downturn by increasing market share and/or reducing staff, downsizing, etc.

Consequently, the ideal candidate company should be providing a product or service in a growing or expanding market, whether it is the geographical location of the service area, i.e. Florida versus West Virginia, or the demographics of the product demand. As further examples, medical products or services for the baby boomers and/or construction or engineering services in rapidly growing Sunbelt regions may be more attractive ESOP candidates than certain types of high overhead, cyclical manufacturing companies in the Northeast, particularly where jobs are vulnerable to outsourcing overseas, plant closures, etc.

The transitional state of the industry is also an important factor. The issue here is whether the company is in an industry subject to a roll-up or consolidation as opposed to being vulnerable to large national competitors. For example, there is currently merger activity returning to the construction, engineering and professional services sector in the form of consolidations. On the other hand, independent hardware stores and garden centers, and even supermarket chains, are extremely vulnerable to big-box competitors, such as Home Depot, Lowes, Costco or Wal-Mart.

Costs and Time

As previously noted, there are a number of elements involved in designing and implementing an ESOP. Expenses for a variety of services include legal, tax and insurance advisors, plan designers, business appraisers, feasibility studies, and other related needs. For small or mid-size businesses, it may not be necessary to engage the services of each and every one of the aforementioned advisors.

A business valuation, plan and document design, in conjunction with some basic tax planning by the legal team, is the normal range of expert services in most smaller, straight forward ESOP plans. Legal fees of course depend on the design of the plan, whether or not there is leveraging (loan documents and other related fees), and related wealth planning needs. Plan designers, financial planners, tax advisors, and appraisers generally charge fees based on an hourly rate, or commissions in the case of insurance providers.

From a valuation perspective, fees can vary greatly depending on the issues involved with a particular business. The scope of the business appraisal will typically include such items as adjustments for family or non-essential operating expenses to a company's historic income statements, balance sheet adjustments for assets not needed in the operation of the business (such as accumulated cash beyond working capital needs or highly appreciated real estate), surplus land, or other assets owned by the corporation but not used directly in the company's business.

Regarding the business valuation, our firm typically recommends providing in the early stages of the process preliminary indications of value utilizing a Summary Report format. This preliminary assessment produces an abbreviated in-depth analysis of the company's valuation, omitting much of the information required in a full compliance document which will be necessary to meet ERISA, DOL, and IRS standards once the plan is in place.

A Summary Report valuation, depending on the scope of work, quality of the financial data provided, nature of the business, etc., will typically cost between $6,500 and $9,500. Full compliance reports, with all of the required regulatory documentation, typically range between $10,000 and $12,000. Annual update appraisals are required under ERISA in order to determine employee participant allocations. The annual updates, which also are required to meet full compliance format standards, generally incur fees between $6,500 and $9,500. Our firm is obviously prepared to discuss the particulars of a possible valuation engagement with prospective clients and/or their professional advisors at any time.

Tax Advantages of an ESOP

As previously discussed, an ESOP is one of the few tax structures that allows pre-tax employer contributions to be used to purchase privately held stock and/or make principal and interest payments on a loan used to purchase stock. In addition, Section 1042 of the Internal Revenue Code provides certain conditions under which the capital-gains tax on the sale of a business to an ESOP can be deferred.

However, at a minimum, the following qualifications must be met for the seller to receive Section 1042 treatment:

1. The company being sold must be a C-corporation. Under current regulations, S-corporations do not qualify for 1042 treatment.

2. It must be a private (non-public) company.

3. The ESOP must own at least 30% of the company immediately after the sale to qualify for deferral treatment.

4. The seller must reinvest the proceeds in Qualified Replacement Property (QRP) within a 15-month period (3 months prior to the sale, but no later than 12 months after the date of sale).

For these and other reasons, we strongly recommend that any business owner consult with a tax advisor before contemplating the sale of a business to an ESOP.

Structural Options

Due to certain changes in the tax law, ESOPs now come in many variations. Before the ESOP concept is rejected or embraced, the prospective company should, at a minimum, communicate with someone like Sheldrick, McGehee & Kohler or another knowledgeable firm, to obtain accurate and reliable information regarding this important decision. For every five or six ESOP candidates our firm is in contact with, only one or two will even proceed to the next step of exploring the opportunity and/or obtaining a preliminary valuation. Conversely, SMK can typically provide in very short order reasons why a given company is not a good ESOP candidate, with some insightful explanation as to why. In conjunction with this assessment, we also try to recommend changes the company might consider implementing that could potentially make it a viable ESOP candidate at some future date.

For those companies that might consider an ESOP, certain variations that are frequently overlooked are as follows:

The Cash Warehouse ESOP is a plan that is established, and contributions are made to the plan, before the first purchase of company stock is actually made. As with any qualified plan, these are pre-tax contributions, are allowed to grow tax-free in the plan, and if the plan qualifies for Section 1042 treatment, may be paid out to the selling shareholder(s) on a tax-deferred basis (*see Tax Advantages Of*

An ESOP above) or at a capital-gains versus ordinary income rate. This strategy is particularly advantageous to companies whose results are currently better than normal, thus they have ample cash flow from with to make the contributions, but for various reasons do not want to commit to start purchasing company shares at this time.

Issuing preferred shares, in lieu of common shares, to obtain a small premium price for the shares being sold to the ESOP Trust. These shares will also carry have a dividend preference over the common.

Other hybrid structures include the combination of a 401(k) and ESOP (also known as a "KSOP") where the employer contributes a 401(k) match to help pay for an ESOP transaction via a single retirement plan, while keeping the more diversified component of the 401(k) plan in place. There can also be Family Limited Partnerships, Family Foundations and Charitable Trusts combined with ESOPs to keep the business in the family, shelter wealth transfers, and/or to provide enhanced tax treatment for a sale.

Summary

In summary, these are broad guidelines and are not meant to be too specific nor too rigid. The ESOP-company candidate should be consistently profitable, well managed, recognized and well positioned in its field, not subject to predatory competition, and operating within a demographically attractive market, both geographically and in terms of product or service growth.

Ultimately the decision to consider an ESOP should be made on the basis of a company's culture and business position, not principally on the tax or liquidity desires of the seller. It is our experience that the most successful ESOPs not only share the characteristics described above, but are owned or controlled by a shareholder (or shareholders) who genuinely believe in sharing both responsibility and success, and in having key managers and all participating employees profit from the company's growth and future success. Most thriving ESOP companies already have the "team" and "ownership" cultures in place, and the ESOP merely formalizes a new ownership structure.

We hope the above is helpful to you and gives you some insight into the world of ESOPs. Please call us at 904/355-4715 if we can answer any questions or provide further insights.

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