National Benefit Services, Inc.

# ESOP as an Exit Strategy

## CBA Financial Committee

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# What We'll Discuss

- Overview: David Blum
- Exit Strategies for the Business Owner: David Blum
- ESOP Essentials: Jerry Kalish
- How An ESOP Gets Done: Grant McCorkhill
- Wrap-Up: Grant McCorkhill

# Overview

# Exit Strategies for the Business Owner

- Transfer Ownership to Children
  - Limited Partnership, valuation discounts
  - Regular Gifting
  - Outright at Death
  - Seller Financed
- Management Buy-out
  - Financing
  - Tax Implications
- Sale to Third Party/Competitor
- Orderly Liquidation
- **Leveraged ESOP**

# Who is an ESOP prospect

- Owner wants to sell some or all of his or her shares on a tax-preferred basis.
- Company must be or convert to C or S corp.
- Sufficient profits to repay loan.
- Sufficient covered payroll to meet deduction rules.
- Proper corporate culture.
- Transaction cost is “reasonable”.

# Take-Away Message

There are an increasing number of business owners who want to cash out, and an Employee Stock Ownership Plan ("ESOP") can be an effective exit planning strategy for them.

# ESOP Essentials

- What’s an ESOP?
- What tax benefits are available
- How a leveraged ESOP works

# What's an ESOP?

Qualified defined contribution plan with two special characteristics:

- Designed to invest primarily in employer stock, and
- Can borrow funds to acquire those shares

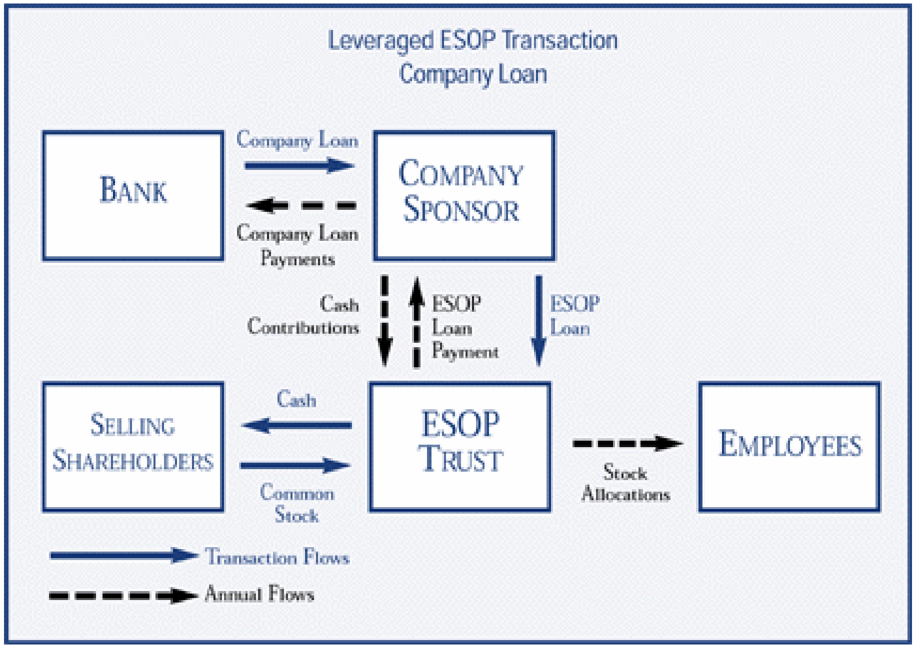
**A corporate transaction that takes place in an ERISA environment**

# What Tax Benefits are Available

- **Higher tax deduction limits**
  - Up to 25% of eligible comp for principal payment
  - Plus deduction for interest payment
  - Plus deduction for “reasonable” dividends if used to repay ESOP loan or passed through to ESOP participants
- **Deferral of gain for seller of C corporation shares referred to as “Section 1042 Rollover”**
  - ESOP must own at least 30%
  - Sale proceeds must be reinvested in securities of U.S. operating companies
- **S corp. ESOP pays no tax on its pro-rata share of earning**

# How does a leveraged ESOP work

1. Company borrows funds from FAB.
2. Second loan (‘mirror loan”) established between ESOP and company.
3. ESOP uses funds to buy shares from shareholders.
4. Company makes tax-deductible contributions to ESOP.
5. ESOP then uses contributions to repay loan to company.
6. Company then uses ESOP payments to repay loan to FAB.



# Take-Away Message

An ESOP is a corporate transaction that takes place in an ERISA environment with special tax benefits that may be appropriate and feasible for many closely held companies.

# How an ESOP Gets Done

- ESOP feasibility
- Client company example
- Financial analysis
- Deal structure for client company
- Key players

# ESOP Feasibility

- Business Broker/Consultant Role
  - Feasibility Study
  - Informational Memorandum
- Bank Role
  - Informational Memorandum & Feasibility Study Analysis
  - Due Diligence

# Client Company Example

- Value: $10.0 MM
- 30% ESOP Transaction ($3.0 MM Credit Facility)
- One Owner
- C-Corporation
- Currently has a $2.5 MM Working Capital Line of Credit
- $1.25 MM EBITDA

# Financial Analysis

- Determining Factors
  - Cash Flow
  - Collateral
- Types of Financing Structures
  - Line of Credit
  - Term Debt
  - ESOP Debt

# Deal Structure for Client Company

- Line of Credit: $2.5 MM Line (Average 50% funded)
- ESOP Debt: $3.0 MM Term Note
  - Term: Four to Five Years
  - Floating rate of LIBOR + 350 basis points (Currently 6.25%)
- Determining Factors
  - Cash Flow Coverage Ratio:
    - Four Years: <u>1.19:1</u>; Five Years: <u>1.38:1</u>
  - Collateral
    - Shortfall Management

# Key Players

- Bank Counsel
- Corporate Counsel
- ESOP/Benefit Consultant
- Valuation Firm
- ESOP Counsel
- ESOP Trustee

# Take-Away Message

An ESOP deal gets done after determining feasibility, structuring the transaction, and involving all the necessary players.

# Wrap-Up