Private Equity and ESOPs: A Creative Combination

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As equity owners of privately held businesses explore exit strategies in a favorable valuation environment, they are faced with an age-old debate: should I (1) sell my ownership position to a private equity (PE) firm, which may recommend a new direction, diminish the family legacy, and potentially sell the business in five to seven years; (2) explore a sale to a strategic buyer, which may require a portion of the purchase price to be paid in an earnout, and will likely eliminate overlapping management, administrative, and sales functions of the combined entity; or (3) hold on to the company with the goal of growing the business and the hope that valuations remain high down the road? With valuation multiples returning to pre-recession levels (as illustrated in figure 4-1[1]), debt financing readily available at favorable rates, and private equity funds estimated to be sitting on more than $350 billion of "dry powder," the first option is becoming increasingly attractive for business owners.

There is, however, a fourth alternative that provides common ground for PE firms looking for a creative edge and tax-conscious business owners who are wary of selling their business outright to a strategic competitor or through a traditional buyout: structuring a sale to an employee stock ownership plan (ESOP) in partnership with a PE firm.

1. The S&P Composite 1500® combines three indices (the S&P 500, the S&P MidCap 400, and the S&P SmallCap 600) to cover approximately 90% of US market capitalization. It is designed to replicate the performance of the US equity market or benchmark against a representative universe of tradable stocks. Please note that the enterprise value (EV) to earnings before interest, taxes, depreciation, and amortization (EBITDA) multiples of public companies reflected above may not be indicative of pricing for smaller, private companies.

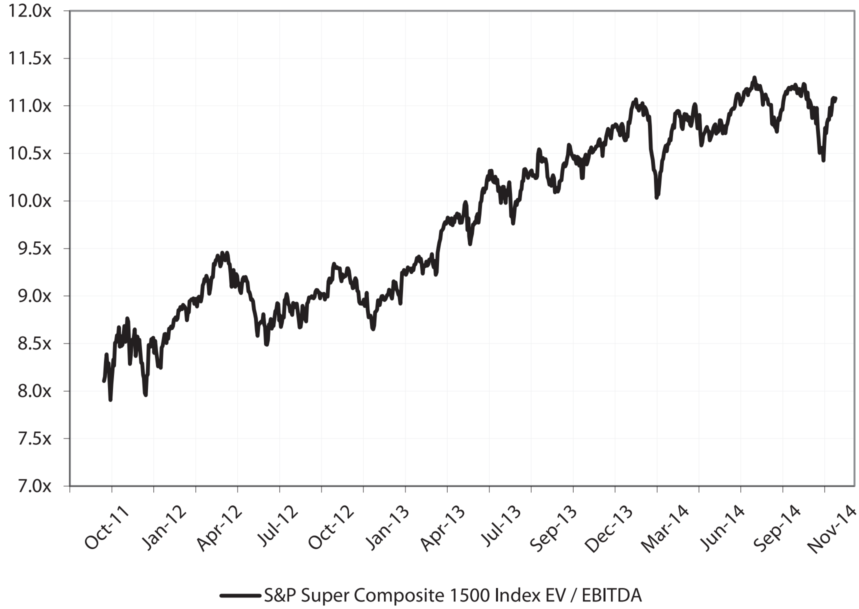

Figure 4-1. General public company valuation multiples

An ESOP is a type of defined contribution benefit plan that can use both borrowed money and existing funds to purchase company stock of the employer. Although ESOPs have been around for decades, an increased understanding of the benefits of ESOPs as a corporate finance tool has resulted in PE firms partnering with ESOPs both as a vehicle for new investments and as an exit strategy for existing portfolio companies. Typical ESOP candidates are companies that could benefit from a corporate culture that encourages employee-led productivity improvements. Other good ESOP candidates are companies with highly compensated and highly educated workforces, since such companies tend to benefit from incentivizing employees to "think like an owner." Since ESOPs are typically implemented using borrowed funds, an ideal target company should also have a relatively stable level of cash flow and an experienced management team. Most companies that have successfully used the ESOP structure recognize that employees are instrumental in creating long-term value for shareholders.

Partnering with a PE firm to facilitate an ESOP co-investment provides several benefits to a selling shareholder that an outright sale of the business does not. First, this structure may allow a selling shareholder to indefinitely defer or eliminate the capital gains taxes from the sale, resulting in significantly more after-tax proceeds than a traditional LBO or a strategic sale. Second, this structure provides the traditional benefits of an ESOP, including corporate tax savings, enhanced cash flow, and improved employee motivation, all of which combine to improve the financial stability and performance of the business. Third, this structure allows the selling shareholders to maintain an attractive investment in the business through an investment in subordinated debt and warrants, which provide a current return and equity upside in the business. Fourth, this structure allows the business to provide liquidity to a desired group (or all) equity holders while staying privately held. These benefits, among others, create a way for equity holders of closely held businesses to gain liquidity on a tax-efficient basis and diversify their wealth while creating a benefit for the company's employees.

PE + ESOP Co-Investment

In a PE-backed ESOP co-investment, the PE firm invests in a company by (1) lending the company subordinated debt with warrants,[2] (2) the proceeds of which are lent by the company to the ESOP, which, in turn, (3) buys the selling shareholders' equity in the company. In most cases the selling shareholder does not cash out completely but rather co-invests part of his or her proceeds alongside the PE firm in the same security purchased by the PE firm. As a result of this transaction, the ESOP is left as the sole shareholder of the target company, which would elect to become an S corporation post-transaction if not one already. While a PE firm could realize enhanced cash flows in C corporations through tax deductible, non-cash contributions to the ESOP, the benefits that can be realized with S corporations are much more significant. Because federal income tax laws permit ESOPs—which are tax-exempt entities—to hold shares of an S corporation, S corporations whose common stock is solely held by an ESOP are exempt from federal income tax.

2. A warrant is a derivative security that provides the holder the right to purchase securities from the issuer at a specific price (the "exercise price") within a certain timeframe.

ESOP Basics

Corey Rosen

An employee stock ownership plan (ESOP) is often the most effective way for a company to share ownership with its employees. Congress created ESOPs in 1974 as a way to encourage the broader ownership of wealth by providing tax incentives to business owners to set up these plans. In return for the tax benefits, businesses agree to comply with various rules to make sure the plans are operated for the benefit of all employees. ESOPs are part of retirement law under the Employee Retirement Income Security Act (ERISA), the same law that governs pension plans and 401(k) plans, and many of the rules are the same or similar.

How Does an ESOP Obtain Stock for Employees?

Employees almost invariably do not buy the stock. (In very rare cases, employees use some of their own assets—usually from an existing 401(k) plan—to buy shares.) An ESOP is a company-funded benefit plan, so there is no out-of-pocket cost to employees. The first step is that the company sets up a trust to hold company shares. The trust can acquire shares in three ways:

1. The company can contribute shares to the trust.
2. The company can contribute cash to the trust (the trust will use that cash to buy shares from existing owners).
3. The most common approach is for the company to have the ESOP borrow money to buy shares, with the company making contributions to the trust to repay the loan.

   The company gets a tax deduction for any one of these approaches.

How Does Stock Get to Employees?

Generally, all full-time employees who have worked for at least 1,000 hours in a year are in the plan. When the shares get contributed to the plan or are purchased by the plan, the shares go into employee accounts.

When the ESOP uses a loan to buy shares, the company makes contributions to the trust equal to the loan payments, and the trust uses that contribution to repay the loan over time. As the loan gets repaid, that percentage of the shares that the trust has borrowed gets released to employee accounts.

The shares get divided up among employee accounts on the basis of relative pay or, sometimes, a more equal formula. The shares in an employee's account are then subject to vesting, so as the employee works more years, more shares belong to that employee, with full vesting after not more than six years.

When employees leave, they can redeem their shares for their fair market value either based on the stock market (if there is one for the company) or a value determined by an independent appraisal.

Tax Benefits

Congress has been generous with tax benefits for ESOPs. Here are some of the key advantages:

- Contributions to the trust, including contributions to repay both principal and interest on an ESOP loan, are tax-deductible.
- In C corporations, sellers to an ESOP can get a tax deferral by selling to an ESOP and reinvesting in other stocks and bonds.
- S corporation ESOP companies do not have to pay tax on profits attributable to the percentage of the company's ownership in the ESOP. A 30% ESOP avoids tax on 30% of the profits; a 100% ESOP pays no federal corporate income tax.

Does It Work?

There is a lot of research on ESOPs. While not every ESOP is a success, overall the idea has been very successful:

- ESOPs increase growth in sales, productivity, and employment by 2.5% per year over what would have been expected.
- Employees have 2.2 times the total retirement assets as employees not in ESOPs.
- ESOP participants are one-third to one-fourth as likely to have been laid off in the last year.

This significantly increases the company's free cash flow, which can be used to repay debt more quickly, to make current interest payments on the subordinated debt, or as capital to grow the company.

If the company was a C corporation to begin with, this structure enables the selling shareholder to take advantage of Section 1042 of the Internal Revenue Code, which effectively allows a selling shareholder to indefinitely defer or eliminate capital gains taxes if he or she sells shares to an ESOP. To qualify for this tax deferral, the target company must be a C corporation at the closing of the transaction (in certain cases in which the company is an S corporation or an LLC, the company may convert to a C corporation to allow the selling shareholders to take advantage of this benefit); the selling shareholders must have held company stock for at least three years; the ESOP must own at least 30% of the stock of the company after the transaction; and the selling shareholder must roll over the proceeds into qualified replacement property, generally consisting of stocks or bonds of US companies. The advantages of electing Section 1042 treatment in connection with a sale to an ESOP have recently increased given the increase in long-term capital gains tax rates and the inclusion of the 3.8% Medicare surtax, which began in 2013. For example, a selling shareholder in California could be faced with an effective combined capital gains charge of up to 33%, based on federal capital gains tax rates of 23.8% and state capital gains tax rate of above 10%. The PE + ESOP co-investment structure, as illustrated in an example of an $80 million enterprise value transaction in figure 4-2, has the potential to generate 20% to 50% more after-tax initial cash proceeds than a traditional PE recapitalization or a sale to a strategic buyer.

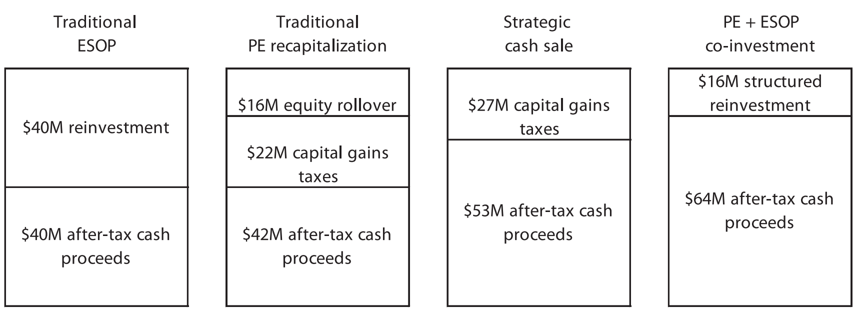

Figure 4-2. Examples of distribution of proceeds to sellers

As an example, assume a typical company ("Company A") has $13.5 million of EBITDA, the ability to borrow an incremental 3.0x times its EBITDA from a senior lender, expected annual revenue growth of 8% with constant margins, and an overall enterprise value of $80 million. Broadly speaking, given the current credit markets, senior borrowing levels in the 3.0x-3.5x range (as a multiple of EBITDA) have become increasingly common for businesses that can support such debt.

In this example, Company A's balance sheet would be used to borrow approximately $42 million of funds from a senior lender (as table 4-1 illustrates), with the PE firm and the seller shareholders financing the balance of the total purchase price in the form of subordinated notes with warrants. The proceeds from the senior debt and subordinated debt would be loaned to the ESOP, allowing the ESOP to purchase 100% of the common stock of the target company. The subordinated notes can be structured at a market-based interest rate with a cashless "payment in kind" feature so as not to burden the target company with an onerous level of annual cash interest payments. In this example, the PE firm and the selling shareholders would loan the company an aggregate amount of $42 million in the form of subordinated debt, paying 10% cash interest with an additional 5% accrued each year. Table 4-1 presents the source and uses of cash of the example transaction.

Table 4-1. Sources and uses of cash

Sources of cash		Uses of cash	
Senior term	42.0	Seller reinvestment—notes and warrants	16.0
PE notes and warrants	26.0	Cash purchase of seller equity	64.0
Reinvestment notes and warrants	16.0	Fees, expenses, and other	4.0
Total sources of cash	**$84.0**	Total uses of cash	**$84.0**

From the view of the PE firm and senior creditor, the cash flow savings from the tax-advantaged PE + ESOP co-investment structure also creates a lower risk profile based on multiples of effective EBITDA. The enhanced cash flow provides flexibility for growth capital, expedited repayment of senior debt, or early repayment of subordinated debt. As table 4-2 illustrates, a company using this structure could reduce its effective third-party leverage ratio by nearly 30%.

Table 4-2. Effective leverage illustration

In millions of USD	PE + ESOP co-investment	Traditional recapitalization
Adjusted EBITDA	**$13.5**	**$13.5**
Depreciation and amortization	(3.5)	(3.5)
Third-party interest	(2.0)	(2.0)
Earnings before taxes	**8.0**	**8.0**
Less: taxes @ 40%	0	(3.2)
Net income	**8.0**	**4.8**
Depreciation and amortization	3.5	3.5
Discretionary cash flow	**$11.5**	**$ 8.3**
Senior debt	42.0	42.0
Effective third-party leverage[a]	**3.7x**	**5.1x**

[a] Reflects senior debt/discretionary cash flow.

In addition to the current cash yield on the subordinated note held by the selling shareholder and PE firm, there is also an increased likelihood that the capital from the reinvestment will be returned in the first five years. Once a portion of initial tranche of senior debt used to finance the ESOP transaction has been repaid, Company A could obtain additional bank financing to repay all or a portion of subordinated notes, providing the subordinated note holders an early mechanism to monetize their investment. For example, Company A would generate between $7 million and $8 million of additional free cash flow after repayment of the required senior debt interest payments. More specifically, by the end of year 3, Company A could reduce its senior debt to EBITDA ratio below 1.5x (as illustrated in table 4-3), at which time Company A could borrow an incremental amount to allow the selling shareholder and the PE firm to partially monetize their initial investment through repayment of the subordinated notes.

To supplement the cash payments and accrued interest, the subordinated notes are typically issued with detachable warrants to provide an all-in internal rate of return (IRR) consistent with market rates of return for securities with similar risk characteristics. The IRR will vary

Table 4-3. Enhanced cash flow illustration

In millions of USD	Year 1	Year 2	Year 3
Adjusted EBITDA	**$13.5**	**$14.6**	**$15.8**
Less: interest expense—senior term[a]	(2.0)	(1.7)	(1.4)
Less: interest expense—PE fund notes and warrants[b]	(2.6)	(2.7)	(2.9)
Less: interest expense—reinvestment notes and warrants[b]	(1.6)	(1.7)	(1.8)
Less: income taxes	0	0	0
Add: retirement savings[c]	1.0	1.1	1.2
Less: capital expenditures	(1.7)	(1.8)	(2.0)
Less: additional working capital	(1.0)	(1.1)	(1.2)
Less: principal payment—senior term	(4.2)	(4.2)	(4.2)
Annual free cash flow	**$ 1.4**	**$ 2.4**	**$ 3.5**
Three-year cumulative free cash flow $7.3			
Ending senior term balance	*$36.4*	*$29.8*	*$22.1*
Senior debt/EBITDA	*2.7x*	*2.0x*	*1.4x*
Total debt/EBITDA	*6.0x*	*5.2x*	*4.5x*

[a]Based on an assumed cash interest of 5% per annum.
[b]Based on cash interest of 10% per annum. Additional interest of 5% accrues annually and is added to principal balance.
[c]Assumes the ESOP replaces a cash plan of approximately 5% of annual payroll.

depending on the underlying company's growth, profitability, exit multiple, overall leverage, and other factors affecting cash flow, but, in general, a PE firm would target an IRR in the high-teens to mid-twenties commensurate with the equity-like nature of a subordinated debt investment in a fully leveraged company. In the example presented here, Company A would issue warrants to purchase company stock for a total of 40% of the company's fully diluted equity, as presented in the simplified structural chart of a example transaction in figure 4-3. The PE firm may attempt to sell the target company before the maturity date of the warrants, in which case the PE firm and the selling shareholder would realize the difference between the pro-rata sale price and warrant exercise price. Alternatively, the company may offer to repurchase the warrants or the warrants may mature, in which case the PE firm and the selling shareholder would receive cash representing the difference between the fair market value of the underlying common stock and the exercise price of the warrants. The market-level interest rate on the subordinated notes, repayment of principal, and the proceeds received from the warrants, in combination with the significantly enhanced cash flows from being a tax-free entity, can provide a PE firm with a similar return on investment relative to a traditional leveraged buyout structure.

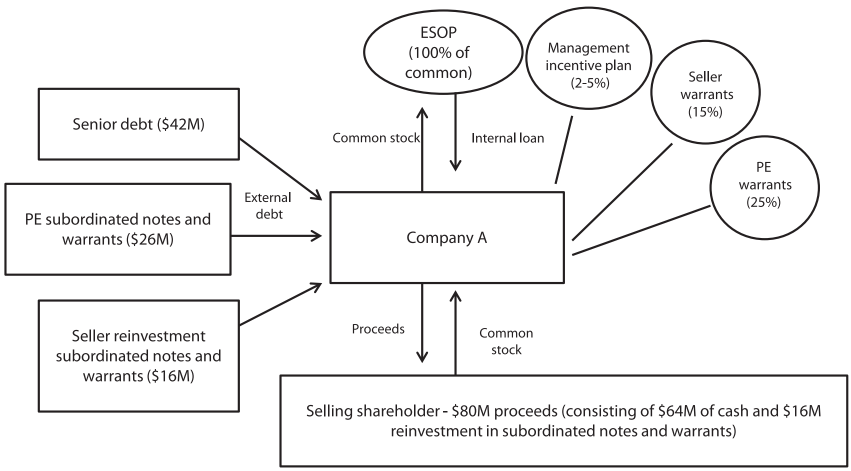

Figure 4-3. PE + ESOP co-investment transaction structure

Control remains an important consideration for most PE firms considering a potential investment. Under this scenario, the ESOP owns 100% of the target company's outstanding common stock post-transaction, with the PE firm holding a subordinated debt position and non-voting, unexercised warrants. Similar to third-party mezzanine financing, the credit agreement for the subordinated notes typically provide members of the PE firm with seats on the company's board of directors, allowing the PE firm to be actively involved in the business. Although it is a common misconception that the trustee of the ESOP (usually a third-party institution) would assume operational and strategic control of the target company after the transaction, this is generally not the case. While the ESOP trustee has exclusive authority and discretion over the management of the ESOP plan assets (i.e., the underlying company stock), ESOP trustees are generally passive investors and rarely get involved in the management of a company unless the corporate directors and officers violate their fiduciary responsibilities. Therefore, the day-to-day oversight and governance of the company remain with the executive management team and the board of directors respectively.

Exit Scenario

Using an ESOP structure as an investment vehicle is not the only creative way PE firms can use ESOPs. A PE firm can also use an ESOP to exit an existing portfolio company. Where a portfolio company may not have the necessary attributes to go public or be sold to a strategic buyer, the ESOP exit strategy may be the best alternative. An ESOP exit strategy is also a perfect option for a business that has group of upcoming executives who are interested in taking the reins and keeping the company private. In addition, an ESOP exit strategy is available if the PE firm is seeking a two-step exit by providing partial liquidity to its investors upon a sale to an ESOP while maintaining an investment in the company to retain future equity upside. The PE firm would get complete liquidity as the company purchases the balance of its investment over time. As a buyer of company stock, an ESOP is permitted to pay up to full fair market value, which is generally interpreted to be what a financial buyer would pay for the stock in a hypothetical, arm's-length transaction between a willing buyer and a willing seller. Therefore, the total consideration paid by an ESOP can typically be as competitive as the consideration paid by other financial buyers. However, an ESOP cannot bid up for synergies, which select strategic buyers tend to pay more for. Furthermore, if the investors in the PE firm are individuals, partnerships, or certain kinds of trusts, the total consideration can be more competitive on an after-tax basis if the sellers elect the Section 1042 tax deferral. Other benefits of using an ESOP to exit a portfolio company include a lower time to transaction completion, lower execution risk, a higher degree of confidentiality, fewer disruptions to the ongoing business operations, and the option of receiving future upside.

Compared to other alternatives, funding for an ESOP exit transaction can come from a variety of sources, allowing the PE firms to receive a sizeable portion of its proceeds at closing and, if necessary, the remainder over time. As previously discussed, due to the significant tax benefits available to ESOP companies, an ESOP company can repay debt more quickly using the enhanced cash flows from realized tax savings. Therefore, commercial lenders with ESOP company experience may be willing to loan more money and provide more favorable terms to ESOP-owned companies. In addition, an ESOP company can use cash previously contributed to an existing 401(k) plan to repay debt incurred to finance the ESOP transaction, since the retirement benefit created by installing the ESOP often provides an equivalent, if not higher, retirement benefit level. Finally, if the transaction is structured properly, the employees of the portfolio company can be provided with a one-time opportunity to participate in a tax-free rollover of their existing 401(k) plan assets to a newly formed ESOP, which can then be used to finance the ESOP exit transaction. If additional funding is required, the PE firm can obtain outside mezzanine financing to completely liquidate its investment at closing, or it can serve as a subordinated lender and take notes with warrants for a portion of the total sale consideration. The principal received by the subordinated noteholders, along with the proceeds received upon the exercise of warrants, can be considered a return of capital, which is taxed at long-term capital gains rates.

Conclusion

As equity owners look for new ways to monetize existing holdings, ESOPs have emerged as a valuable exit tool for selling shareholders. A PE firm that co-invests through an ESOP structure may offer the most attractive liquidity solution for a selling shareholder. This transaction provides significant advantages to a selling shareholder, including the ability (1) to defer or eliminate its capital gain tax, (2) to reinvest in the business in an attractive security that includes a current cash return plus equity upside, (3) to provide an attractive retirement benefit to reward its employees, and (4) to provide a legacy to the seller shareholders and their employees. Under most scenarios, a PE + ESOP co-investment can generate a comparable return on investment relative to traditional buyout structures. Additionally, an ESOP is an attractive structure because it provides an opportunity for a seller to realize a price comparable to a third-party sale price and pass future growth opportunities to existing employees. Finally, in certain situations, a PE firm may use an ESOP transaction as an alternative transaction to generate liquidity for its investors.