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I write about entrepreneurs' exit strategies, ESOPs and M&A.

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Middle Market M&A Innovation: The Private Equity-ESOP Hybrid

In the middle market M&A world, aggressive would-be buyers and their advisors will often tell you one of the following, depending on what business they're in:

–"You certainly don't want to sell to your competitor."

–"Whatever you do, don't sell to a private equity firm."

–"Don't even think about an ESOP – they're too complicated."

The truth is, of course, any founder-entrepreneur-owner of a middle market company nearing time to develop an exit strategy would be nuts not to consider all three options. What's more, hybrid buyers are also emerging, in some notable cases combining the financial firepower and operational expertise of a high-quality private equity firm with the superior productivity and tax treatment of an ESOP.

Some purists in the Employee Stock Ownership Plan community think it's disloyal to team up with a private equity fund. However, private equity players can be an important source of capital for the ESOP community, enabling business owners to achieve their goals of greater wealth diversification. Increasing employee ownership across the economy, helping solve the national retirement savings crisis, and boosting the productivity and competitiveness of American industry — ESOPs do all that. And if private equity partners help us create more ESOPs, that's all to the good.

One of the leaders of the hybrid movement is Long Point Capital, a private equity firm that has raised middle market acquisition funds of $140 million, $170 million and, late last year, $240 million. I recently sat down with Long Point's co-founder and managing director, Ira Starr, to discuss the use of an ESOP alongside private equity in acquisitions.

Mary Josephs: So, you're a private equity shop but you've sold four portfolio companies to ESOPs and you've bought two companies in partnership with ESOPs. How'd that happen?

Ira Starr: We invested in Sunbury Textile Mills in 2002. It performed very well its first two years and when we discussed the sale of the company with the management team, they asked if we'd sell to an ESOP. While my initial response was no, they said, "Would you spend more than 10 seconds thinking about it?" So I did. I went to the ESOP conference in Las Vegas, met you there, Mary, and talked to enough experts to realize that a sale to an ESOP was doable. We created a 100% ESOP exit in which the Company redeemed some of our stock for cash and we kept an investment in the company consisting of structured equity, which is a subordinated note with warrants. The company continued to perform well and within two years it repurchased our structured equity investment, remaining a 100% ESOP. The company asked me to stay on the board, but I didn't give ESOPs much more thought.

Then a few years later, the management team of our portfolio company Atlantic Plywood asked me if we would sell to an ESOP. We ended up exiting the deal using a 100% S-Corp ESOP structure similar to the Sunbury transaction. Recession hit right after that so we were in it for another three or four years before the company was able to refinance us out. But, it all went very well and they asked me to stay on the board, too.

Both are cyclical companies that survived the Great Recession – and I think being an ESOP helped. The employees own the business and that helped them get through a difficult time in the economy.

Josephs: So, after that, you saw the value an ESOP can bring to seller and buyer?

Starr: Both of these companies performed quite well after we sold them to the employees using an ESOP. Maybe it was the motivation of the employees, maybe the tax characteristics. After our positive experiences, we thought maybe we should structure our initial investments using an ESOP. That way, the company gets the benefits we bring as a private equity investor and the benefits provided by employee ownership.

Now we offer entrepreneurs a choice: we will invest in the company using a normal private equity transaction, or as an ESOP-private equity transaction. We explain to them that if we use our ESOP structure, they may be able to defer or eliminate their capital gains tax and they will improve employee motivation and productivity through employee ownership. Finally, since 100% S-Corp. ESOP-owned companies don't pay federal or most state income taxes, the company generates more cash flow allowing for additional investment in the business and paying down of debt. Taxes are paid by the participants in the ESOP when they sell their shares, just like IRAs and 401(k)s.

We have invested in a staffing firm and a restaurant business using this 100% S-Corp. ESOP structure. We invested in structured equity, which was designed to have a similar return profile as if we had done a more traditional private equity transaction. The entrepreneurs invested in structured equity alongside of us. This was a stronger transaction for all of us.

Still, when I mention an ESOP, some entrepreneurs don't want to talk about it. They have a lot of misconceptions about ESOPs. They act just like I did the first time I heard an ESOP suggested. So we just focus on the advantages. Deferral or elimination of the capital gains tax. Employee motivation and productivity. Corporate income tax reduction. And the legacy factor – especially if you're a family company, a lot of people are proud to reward their employees and sell to them.

Josephs: Ira, how are your private equity/ESOP transactions different from traditional ESOP transactions?

Starr: We structure our transactions to deliver more cash to the owner. This allows the owner to diversify his wealth in the company. We reduce his risk of having "all of his eggs in one basket." Most ESOPs are financed with just bank loans and seller financing. We provide more capital, which puts more cash in the hands of the owner. Otherwise, the deals are structured the same way as traditional ESOPs.

Josephs: How'd you get into private equity, Ira?

Starr: I was educated as an engineer at Princeton, decided I wanted to work in venture capital, but couldn't find a job. So I went to work as a strategy consultant at Booz Allen, went to Harvard Business School and then landed at Merrill Lynch as an investment banker where I raised high yield financing for private equity firms. One of my clients, MLGA, asked me to join them to do private equity investing and M&A advisory work.

Josephs: How did you create Long Point Capital?

Starr: My partner Gerry Boylan and I decided to create our own private equity firm, Long Point Capital, in 1998. Gerry had been my client as vice president of business development at Masco Corporation, where he'd done approximately 35 acquisitions.

We just raised our third fund, $240 million. Our earlier funds were $140 million and $170 million; twenty transactions in the two funds. Now, our team is 11 people.

Josephs: The case for selling to an ESOP has only gotten stronger.

Starr: Absolutely. In 2013, the federal capital gains tax rate was increased to 23.8%. Including state taxes, the marginal capital gains tax can approach 35%. I realized that we should be educating people on the benefits of the Internal Revenue Code Section 1042 "tax-free" rollover transaction. If structured properly, a seller can defer or eliminate their capital gains tax through a sale to an ESOP.

Imagine that: we can save a seller up to 35% of their proceeds. Owners of private companies spend a lot of time trying to manage their estate taxes. The 1042 rollover is a tax incentive created by Congress to promote employee ownership. It's not anything fancy.

You'd be amazed that many owners claim that they are not interested in selling to an ESOP because they think it's complicated. Their accountant or lawyer says it's complicated. They don't even think about it – just like my original reaction. Truth is, it doesn't take any longer than a normal private equity transaction.

Josephs: I want your take on worker productivity and lower friction with management at ESOPs.

Starr: Qualitatively, I can say it helps. And of course there's ample ESOP research to back that up. Some companies do it really, really well. What you want is participatory management, explaining to every employee that what they do to benefit the company can benefit them. Atlantic Plywood and Sunbury, I think, captured a lot of these productivity benefits.

Josephs: Before we go on, I get what ESOPs bring to these companies. What's your firm's contribution? I know from Atlantic Plywood's CEO, Paul Vella, that he feels Long Point helped instill financial and operating discipline that helped get his company through the Great Recession. How do you see your contribution?

Starr: Every company in our portfolio has different characteristics and needs but there is more commonality than differences in areas that can create value. We can add value by exposing management teams to best practices. We bring a lot of experience in areas such as strategy, finance, operations and M&A and we have a network of resources that we make available to the management teams of our portfolio companies. For example, in Atlantic Plywood's case, we helped bring financial discipline to the company. We showed the management team the key levers to create equity value. We set clear objectives and used metrics to track success. Once they understood the levers, they were very good at creating the value. We focus on the areas that we think can create the most value for the stakeholders. It's basic business experience, generated through years of experience with many different companies over diverse business cycles.

Josephs: Fair enough. Any trouble meshing governance requirements of ESOPs with those of private equity?

Starr: The ESOP trustees want the companies to be governed on behalf of the shareholders. We're instructed by our investors to do the same. The trustee understands that. So whatever creates value for us will be good for the ESOP. We're completely aligned. We set up a board that consists of us and the management team and the former owners – just the same as we do with our non-ESOP portfolio companies. For our ESOP transactions, we hire a recognized trustee, who we insist retains an experienced law counsel and a well-respected valuation advisor.

Josephs: Thanks, Ira.

Mary Josephs, former head of ESOP advisory at Bank of America, is founder and CEO of Verit Advisors, investment bankers specializing in ESOPs. You can reach her at CEO@verit.com.