ESOPs and Private Equity

Long Point Capital

Ira Starr

Istarr@longpointcapital.com

The Beyster Symposium
June 26-28, 2016

ESOPs and Private equity

- **Employee Ownership can Transform a Company**

  "Done right, employee ownership can transform a company, improve performance and accelerate growth. It can create a sustained competitive advantage, driving business success that builds wealth for founders, investors and employee shareholders alike." - Beyster Institute website.

- **Private Equity Focuses on Actively Managed, Long Term Value Creation**

  "We like to think of ourselves as industrialists. I'm using industrialists in a broad sense. We buy a company and look at what we can do to make it better. How can we improve operations? … It's our long-term approach, the fact that we focus on stakeholders. We used to pay more attention to the stockholder: How well did you do on this investment? Today we worry about the environment, the community, the employees—they're all top of the mind." - Excerpts from a Henry Kravis Interview with Bloomberg, June 2016

ESOPs and Private Equity Investors
Share Common Goal of Long Term Value Creation

Private Equity and ESOPs
why it should make sense?

- **Comparable Return for Comparable Risk can be Achieved**
  - PEG can often structure the investment so that the projected returns are roughly equal in both alternatives since the Private Equity Group (PEG) is taking the same comparable risk in the Traditional PE structure and the PE+ESOP structure
  - PEG should be roughly indifferent as to structure based on projected returns
- **PE+ESOP Offers Significant Employee, Tax and Motivational Benefits**
  - Employee retirement plan benefits created at no cost to employees
  - Corporate income taxes can be reduced or eliminated
  - All stakeholders are motivated to create equity value and wealth
- **PE+ESOP is Aligned with the Objectives of the ESOP and the Trustee**
  - Valuation - Private equity establishes a market-based valuation, i.e. professional investors risking money on an arms-length negotiated transaction value
  - Governance – Private equity establishes governance procedures to maximize growth in equity value which benefits the investment by the ESOP and the private equity firm
- **Robin Hood Results ?**

ESOPs and Private Equity Groups

Where Do They Intersect?

- **ESOP Creation - As an Investor in a New ESOP**
  - A PEG may provide capital to allow an owner to generate liquidity when selling his company to an ESOP
- **ESOP Creation - As a Seller to a New ESOP**
  - A PEG may sell a portfolio company to an ESOP
- **Existing ESOP Financing**
  - A PEG may provide capital to an existing ESOP company in need of financing
- **ESOP Termination**
  - A PEG may purchase a company from an ESOP

PRIVATE EQUITY IN ESOPS
WHEN WILL A PRIVATE EQUITY GROUP INVEST IN AN ESOP ?

- **The Projected Investment Returns Justify the Risk**
  - The returns are similar to the returns that would be generated for a similar risk profile in an alternative investment
- **The PEG can Create Value and Protect and Exit Its Investment through Proper Governance Provisions**
- **The PEG can Structure its Investment to Meet the Constraints Imposed by the Tax code and ERISA**

Private Equity and ESOPs
What are PEG Alternatives for investment?

Transaction Alternative	How Does it Work?	Benefits
Traditional Private Equity Transaction	– Cash is generated through an equity investment by the PEG and third-party debt financing – Owners receive proceeds consisting of cash and an equity interest in the ongoing company – Typical transaction split of value – 80% plus in cash, 20% in equity reinvestment	– PE Group can provide significant value through additional expertise, relationships and capital – Incentives can be created through management options and culture change may be minimal
PE+ESOP Transaction	SAME AS ABOVE BUT: – Typically structured as a 100% S-Corp ESOP – Synthetic equity investment (notes and options) used by the PEG instead of a traditional equity investment. – Owners receive proceeds consisting of cash and synthetic equity (notes and options)	SAME AS ABOVE PLUS: – Employee ownership and retirement benefits created. – Seller's taxable gain can be reduced or eliminated if structured through a IRC 1042 exchange, potentially eliminating a tax liability that could approach 35% of proceeds. – Corporate taxes can be reduced or eliminated. – PEG, Seller and ESOP are aligned in desire for fair price and future equity value creation

Private Equity and ESOPs
What are the Obstacles?

- **Structural Considerations**
  - Legal and Ownership form of corporation may reduce tax benefits of a PE+ESOP transaction – capital gain deferral/elimination only possible with a C-Corp
- **Complexity and Expertise Considerations**
  - Most PEGs and M&A advisors typically do not possess the expertise to evaluate the PE+ESOP structure and often will shoot it down rather than engage outside experts
- **Awareness and Perception Considerations**
  - "Too Good to be True" – If it is possible to eliminate capital gains taxes and eliminate corporate taxes, then why isn't everyone doing it?
  - ESOP myths and misunderstandings lead to negative perceptions
- **Intermediary Incentive Considerations**
  - If an investment banker is engaged by a seller, he is virtually always incentivized to maximize the price/valuation without any regard for tax considerations
  - In the mind of an investment banker, the PE+ESOP transaction creates additional risk – timing, complexity – without any economic upside
- **Regulatory Considerations**
  - DOL regulates retirement plans, including ESOPs, adding another party to the mix

PRIVATE EQUITY AND ESOPs
HOW TO OVERCOME THE OBSTACLES?

Intention	Idea
Make ESOPs More Attractive to Sellers • Will drive sellers to demand the ESOP alternative to achieve its tax benefits	Extend IRC 1042 Exchange to S-Corps, the corporate structure for the vast majority of private companies, allowing more sellers to benefit from capital gain deferral/ elimination.
Make ESOPs Attractive to Impact Investors • Will incentivize PEGs to learn about ESOPs to create new investor base	Educate Impact Investors on the social benefits of ESOP creation. Educate Impact Investors that they can achieve social benefits without sacrificing returns through a PE +ESOP investment.
Make ESOPs Less Complicated to Execute • Execution of an ESOP is sometimes as much an art as a science – clear cut guidelines will makes it more attractive to PEGs	PE+ESOP transactions are market based valuation transactions – there is a buyer looking for the lowest price and a seller looking for the highest price. A traditional ESOP is a a self-dealing transaction. ESOP trustees must learn to evaluate PE+ESOP deals differently from traditional ESOPs.
Demystify ESOPS and Clear Ups Myths • Don't drive away PEGs and Sellers because of misinformation.	ESOP industry associations could create better communication programs to create clarity.

Private Equity and ESOPs
How to Overcome the Obstacles?

Intention	Idea
Publicize ESOP Success Stories • Creating a positive public perception of ESOPs would lead more PEGs, sellers and employees to suggest a company sale to an ESOP.	ESOPs industry associations should help to publicize successful ESOPs. Newspapers tend to run negative stories about ESOPs, e.g. Chicago Tribune, creating negative public perception.
Educate PEGs on Productivity Benefits of ESOPs • If PEGs believe that employee ownership will create more value for their investors, they will be more open to the PE+ESOP transaction	Create academic studies that measure the economic benefits of ESOPs and employee ownership.

PRIVATE EQUITY AND ESOPS
SUMMARY OBSERVATIONS?

- **It Can Work - PEGs Have Invested in ESOPs**
  - At least half a dozen PEGs have invested in ESOPs, but typically each has invested one time only
- **Long Point Capital is the Leading PEG Investing in ESOPs**
  - Long Point Capital (LPC) has created over 3,000 employee owners in seven ESOPs since 2004
  - LPC offers the PE+ESOP transaction to sellers who value the benefits of the ESOP versus a traditional PE transaction
- **PE Investment in ESOPs Will Grow If:**
  - PEGs see a competitive advantage in offering an ESOP alternative.
  - Sellers recognize the benefits of an ESOP and demand that PEGs offer it as an alternative

Appendix

Liquidity Options

to Owners of Companies

Why might an owner Explore Liquidity Options ?

- Exit Strategy Planning
  - You want to diversify your assets and reduce the risk of having "all your eggs in one basket"
  - You want to preserve an ongoing role and maintain equity ownership in the Company
- Retirement
  - You are looking to sell the entire Company and retire
- Family Succession
  - You need to provide for liquidity for an older generation as part of an appropriate succession plan
- Partner Buyout
  - You need to generate the cash to repurchase the stock of a significant shareholder

WHAT ARE THE GOALS OF AN OWNER WHEN EXPLORING A SALE TO AN ESOP ?

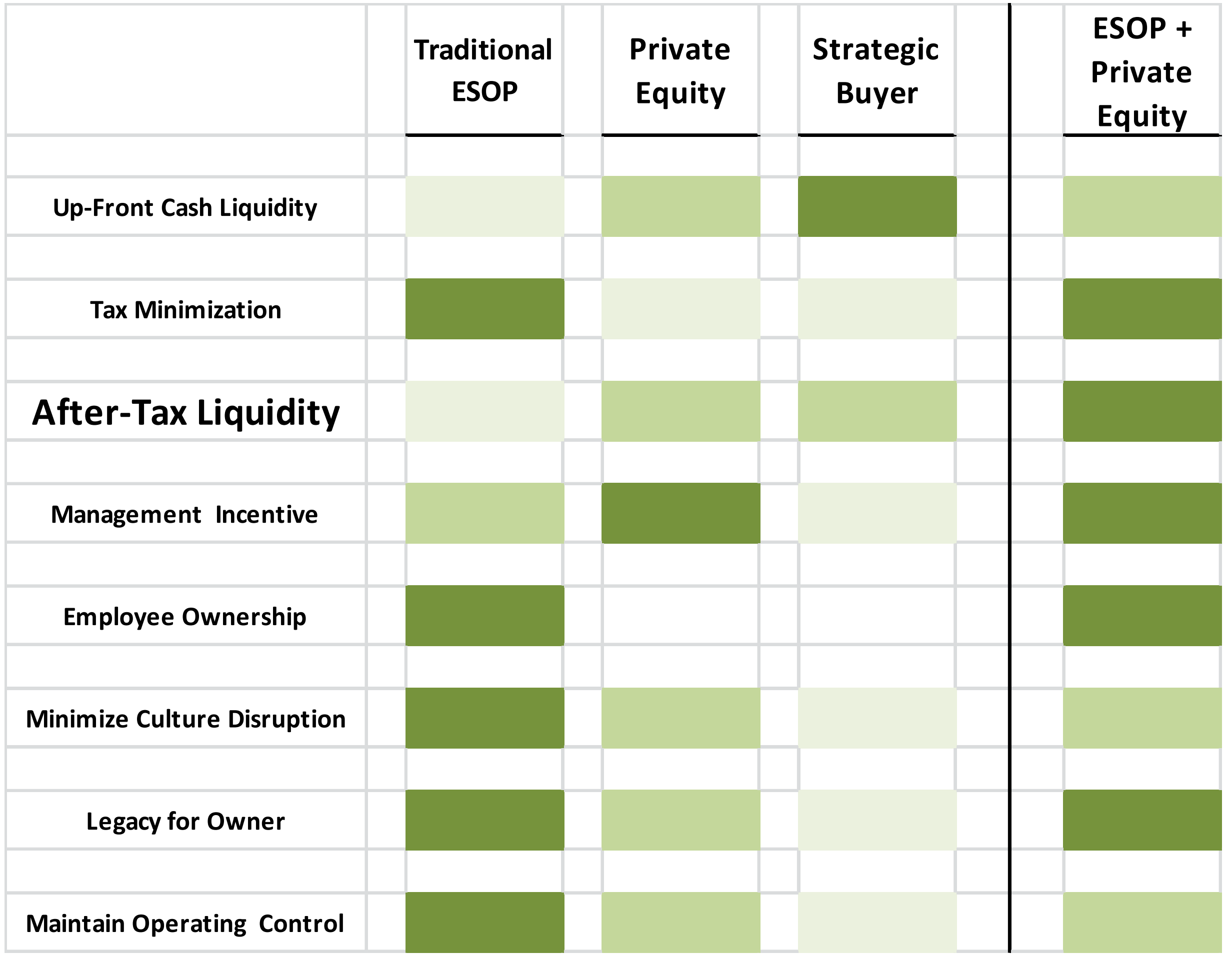
- **Liquidity (Cash)** & Wealth Diversification

- Tax Minimization
- Management Team Incentive
- Employee Ownership
- Minimization of Culture Disruption
- Legacy for Owner
- Maintain Operating Control

WHAT ARE THE ALTERNATIVES TO AN ESOP?

- Hire an Investment Banker and
  - Sell to a Private Equity Firm
  - Sell to a Strategic Buyer
- Do Nothing

How Do the Alternatives Meet the Goals ?

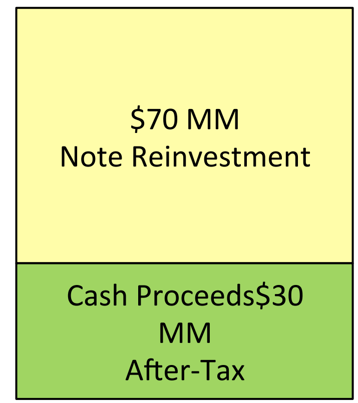


The ESOP + Private Equity Alternative looks attractive – why isn't it more popular?

Sell to a Traditionally Financed ESOP

- What is it?
  - Cash is generated using only a senior loan from a bank
  - Owners receive proceeds consisting of cash and a seller note
  - Typical transaction split of value – 30% to 40% cash / 60% to 70% seller note
- Benefits
  - **The taxable gain can be reduced or eliminated if structured using IRC Section 1042, potentially eliminating a tax liability that could approach 35% of proceeds in CA**
  - Corporate taxes can be reduced or eliminated if structured as a 100% S-Corp structure or using certain ESOP loan structures
  - Incentives can be created through options and employee ownership and culture change is minimized
  - Control is maintained by the owner, if desired
- Issues
  - Significant wealth diversification is not achieved because of limited cash liquidity

$100 MM Traditional ESOP



SELL TO A PRIVATE EQUITY GROUP

- What is it?
  - Cash is generated through an equity investment by the PE group and debt financing arranged by the PE group
  - Owners receive proceeds consisting of cash and an equity interest in the ongoing company
  - Typical transaction split of value – 80% plus in cash, 20% in equity reinvestment
- Benefits
  - **More cash at closing** because of PE investment and additional debt financing generated by PE group
  - PE Group can provide significant value through additional expertise, relationships and capital
  - Incentives can be created through management options and culture change may be minimal
- Issues
  - Tax Inefficient – Owners pay capital gains taxes / Company pays corporate taxes
  - PE group will typically control the Company

$100 MM Sale to a PE Group

$20 MM
Equity Reinvestment

$24 MM
Capital Gain Taxes

$56 MM
After-Tax Cash Proceeds

SELL TO A STRATEGIC BUYER

- What is it?
  - Strategic buyer, often competitor, pays cash or stock, if public
- Positives
  - **Potential for most pre-tax liquidity** if buyer attributes value to and pays for synergies
  - No further risk in company investment for existing owner
- Issues
  - Tax Inefficient – Owners will pay capital gains taxes on cash, potentially mitigating value of higher price
  - Elimination of owner upside in Company
  - Complete lack of control over future of business
  - Most potential for culture shock to management team and employees
  - Risk of release of competitive information through the sale process

$100 MM Sale to a Strategic Buyer

$30 MM Capital Gains Taxes
$70 MM After-Tax Cash Proceeds

What is Private Equity and How Can It be Used in an ESOP?

- Private Equity is institutional capital used for investment in private companies with the goal of generating a risk-adjusted equity return

- Private Equity can provide additional liquidity to an owner in an ESOP transaction through an investment in the Company, which allows the owners to receive more cash and create more wealth diversification.

Private Equity 101
Risk-Adjusted Return on Investment

- Investing - The Greater the Risk Taken, the Higher the Return Required
- Risk is Associated with:
  - Certainty of Cash Flow
  - Size of Company – the larger the company, the less the risk
  - Leverage – the less the debt, the less the risk
  - Industry Cyclicality – the more stable the industry, the less the risk
  - Diversification – the more the diversification, the less the risk
  - Liquidity – the easier it is to sell the investment (e.g. public), the less the risk
  - Maturity – the longer the company has a track record, the less the risk
- Private Equity takes Risks
  - Typically invests in smaller private companies using equity and debt (highest risk profile)
  - Typically seek annual returns of 25% + on investments
- Valuation Multiples are based both on **risk** and on **growth** potential

Private Equity 101
Objectives, Governance and Liquidity

- Objective – growth of equity investment value is paramount; that is how private equity professionals are paid
- Governance – active investors aligned with management
  - Active with management team to grow company
  - Alignment of Interests – management teams incentivized to create equity value
  - Control – If company is not performing, PE group must have ability to change team
- Liquidity – investment horizons typically 5 years, require ability to generate cash liquidity for PEG investors, typically through sale of company

Private Equity in ESOPs – Tax Issues

- Most Tax Efficient ESOP Structure – 100% S-Corp. Structure
- But if the Equity of the Company is Owned 100% by an ESOP, how can a Private Equity firm invest?
- Synthetic Equity needs to be utilized
  - Consists of a Junior Debt Investment with an Equity Kicker (e.g. Options)
  - Designed to generate an investment return which mimics the return that would be generated through a traditional private equity transaction
- Complicated to structure and experienced tax advisors required to insure that all rules are met

Private Equity in ESOPs – Financing Issues

- 100% S-Corp ESOPs are 100% Debt Financed Companies
- Financing Consists of:
  - Senior Lender Debt – may be bank or non-bank lender
  - Structured Equity (Junior Debt)
  - Seller Notes (Junior Debt)
- Banks require the junior debt to be appropriately subordinated to the bank's senior debt
- Requires a sophisticated senior lender who understands the structure
- Investment by private equity may increase confidence of senior lender

Private Equity in ESOPs – Financing Benefits

- 100% S-Corp ESOPs generate significantly higher free cash flow due to the elimination of taxes.
- The higher free cash flow may allow the lender to:
  - Stretch and lend more to the company than it would lend to the same company that is a tax-payer, or
  - Provide more flexible rates and terms since the company should be perceived as a better credit.
- The higher free cash flow provides significant benefits to the Company, providing:
  - More capital for growth, and/or
  - More capital to deleverage rapidly, and/or
  - Current cash yield on the synthetic equity notes

Private Equity in ESOPs – Regulatory Issues

- Private Equity is well aligned with the primary objectives of the ESOP and the Trustee
  - Valuation - Private equity establishes a market-based valuation, i.e. professional investors risking money on an arms-length negotiated transaction value
  - Governance – Private equity establishes governance procedures to maximize growth in equity value which benefits the investment by the ESOP and the private equity firm
- Constraints
  - ESOPs are regulated by the Internal Revenue Code and ERISA, so careful adherence to IRC and ERISA rules is required

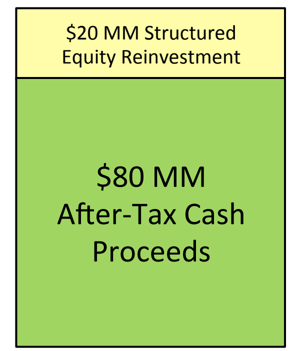
Private Equity in ESOPs – When Does it Work ?

- **When will a Private Equity Group (PEG) invest in an ESOP?**
  - The projected investment returns justify the risk
    - The returns are no less than the returns that would be generated in a traditional PEG purchase of the company
  - The PEG can create value and protect its investment through proper governance provisions
  - The PEG can structure its investment to meet the constraints imposed by the tax code and ERISA
  - The PEG can find sufficient debt financing for the transaction
- **If it works, it provides a new alternative ……**

NEW ALTERNATIVE: SELL TO A PE-BACKED ESOP

- What is it?
  - Structured as a traditionally financed ESOP, but cash is generated through a synthetic equity investment (notes and options) by the PEG and bank loans arranged by the PE group
  - Owners receive proceeds consisting of cash and synthetic equity (notes and options)
  - Typical transaction split of value – 80% plus in cash, 20% in synthetic equity reinvestment (notes and options)
- Positives
  - **The taxable gain can be reduced or eliminated if structured through a IRC 1042 exchange, potentially eliminating a tax liability that could approach 35% of proceeds.** Corporate taxes can be reduced or eliminated if structured as a 100% S-Corp ESOP or alternative structures.
  - **MOST AFTER-TAX LIQUIDITY** – more cash, less taxes
  - PEG can provide significant value through additional expertise, relationships and capital
  - PEG, owner and ESOP are aligned in desire for fair price and future equity value creation
  - Maintain incentives through options and employee ownership
- Issues
  - PEG will play important role in governance of the Company

$100 MM
PE + ESOP
Transaction



How Do the Alternatives Meet the Goals ?

	Traditional ESOP	Private Equity	Strategic Buyer	ESOP + Private Equity
Up-Front Cash Liquidity				
Tax Minimization				
After-Tax Liquidity				
Management Incentive				
Employee Ownership				
Minimize Culture Disruption				
Legacy for Owner				
Maintain Operating Control				

The ESOP + Private Equity Alternative looks attractive – why isn't it more popular?