

IMPACT INVESTING, ESOPs AND PRIVATE EQUITY



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HOW DOES IMPACT INVESTING INTERSECT WITH ESOPs AND PRIVATE EQUITY ?

- **What is Impact Investing?**
 - Impact investments are investments made with the intention to generate **positive, measurable social and environmental impact** alongside a **financial return**.
- **ESOPs => positive, measurable social impact**
 - ESOPs can address **wealth inequality** through a newly created retirement plan at now cost to the employees
 - Wealth inequality has not traditionally been a goal of impact investors and therefore has not attracted impact investor attention
- **Private Equity => strong financial returns**
 - Private equity can invest in ESOP transactions, generating comparable returns for comparable risks

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
- **Generates Impact Investing Results**
 - Measurable impact (wealth creation) with strong financial returns

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	<ul style="list-style-type: none"> – 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 	<ul style="list-style-type: none"> – 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	<p>SAME AS ABOVE BUT:</p> <ul style="list-style-type: none"> – 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) 	<p>SAME AS ABOVE PLUS:</p> <ul style="list-style-type: none"> – 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
<p>Make ESOPs More Attractive to Sellers</p> <ul style="list-style-type: none"> Will drive sellers to demand the ESOP alternative to achieve its tax benefits 	<p>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.</p>
<p>Make ESOPs Attractive to Impact Investors</p> <ul style="list-style-type: none"> Will incentivize PEGs to learn about ESOPs to create new investor base 	<p>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.</p>
<p>Make ESOPs Less Complicated to Execute</p> <ul style="list-style-type: none"> Execution of an ESOP is sometimes as much an art as a science – clear cut guidelines will makes it more attractive to PEGs 	<p>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 self-dealing transaction. ESOP trustees must learn to evaluate PE+ESOP deals differently from traditional ESOPs.</p>
<p>Demystify ESOPS and Clear Ups Myths</p> <ul style="list-style-type: none"> Don't drive away PEGs and Sellers because of misinformation. 	<p>ESOP industry associations could create better communication programs to create clarity.</p>

PRIVATE EQUITY AND ESOPs

HOW TO OVERCOME THE OBSTACLES?

Intention	Idea
Publicize ESOP Success Stories <ul style="list-style-type: none">• 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 <ul style="list-style-type: none">• 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
- **Success Stories – It Does Work**
 - 2 ESOPs that LPC created were sold in the past two years, generating approximately \$60 million in proceeds for about 300 employees, almost \$200,000 average per person, most of whom were hourly workers
- **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