Employee Stock Ownership Plans

Are they an Advisable Exit Strategy for Business Owners?

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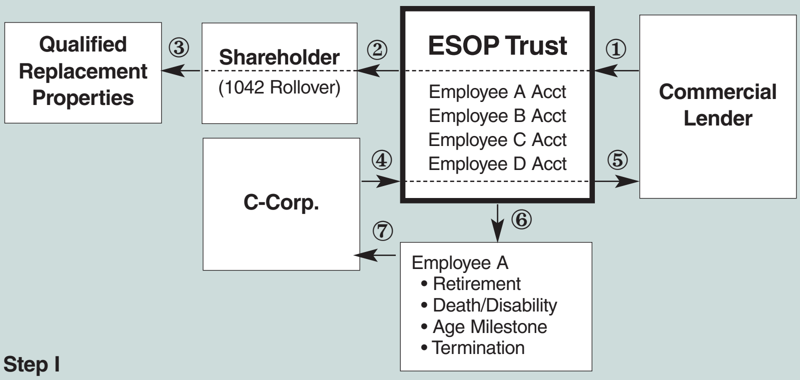
An Employee Stock Ownership Plans, or ESOP, is a means by which the employees of a company acquire ownership of that company through a shareholder purchase arrangement. The ESOP is often described as an alternative to the management buyout, known as an MBO, whereby the existing management team of a business purchases that business. (See full discussion of an MBO in "The Management Buyout - Anatomy of a Deal" CGI October 2005.)

An ESOP is best suited to acquisitions in which most or all of the employees of the company being sold are interested in an ownership share. One of the advantages of an ESOP is that it opens an acquisition to a larger pool of employee/buyers. ESOPs emerged in the United States in the early 1970s and have come in and out of favor based on different economic cycles, changing tax laws, and general management and ownership succession theory. Today, it is estimated that there are between 11,000 and 12,000 ESOPs operating in the US.

As advisors to business owners considering their options for transitioning ownership, Leaders LLC is often asked whether an ESOP is a viable alternative. Most business owners have heard that there are major tax benefits of selling to an ESOP, while at the same time rewarding the employees who have helped them build their businesses over the years. While this is true under many circumstances, an ESOP is not always an advisable ownership transition strategy for a business owner seeking to exit the business. The answer will ultimately depend on a number of specific personal and business related factors. This article highlights some of the most important factors to consider when determining if an ESOP is an option worth exploring as a means of transitioning ownership of a privately held business.

Figure A



Step I

(1) ESOP borrows money from a commercial lender to purchase shares of stock from the selling shareholder.

(2) Shares are purchased from the selling shareholder and held in the ESOP trust.

(3) Selling shareholder can defer taxes due on the sale of stock by "rolling over" the proceeds into QRPs (essentially individual company stocks, bonds, warrants or debentures).

Step II

(4) The company makes annual tax-deductible distributions to the ESOP from the cash flow of the business.

(5) The cash distributions made by the company to the ESOP are used to pay back the principal and interest on the loan.

Step III

(6) When an employee leaves the company or reaches certain age-related milestones, the vested shares in their account are distributed to them from the ESOP.

(7) The employee can sell the shares back to the company, either immediately or at other age-based milestones.

WHAT IS AN ESOP AND HOW DOES IT WORK?

As initially envisioned, ESOPs were intended to serve as an employee benefit program, whereby employees were given an ownership interest in the company as a retirement benefit, while at the same time creating an incentive for the employees to act in a way that was in the best interest of the company. While this remains one of the primary reasons for establishing ESOPs, the more common reason that ESOPs are created today is as a means for a retiring shareholder to sell his or her ownership in the business. So how does it work?

When a company establishes an ESOP, it creates a trust that holds the shares of stock being purchased (or contributed) from either the company or the selling shareholder. The shares held in the trust are allocated to individual employees on a predetermined formula based on, for example, relative compensation, years of employment, or some combination thereof. "Ownership" of these shares by the individual employee is typically vested over a five to seven year period. When an employee leaves the company or retires, the vested shares in the employees account are distributed to the employee from the trust. Depending upon the terms of the ESOP, the departed employee can either sell the shares back to the company (or on the public market if publicly traded) or hold on to them for disposition at a later date. Since this article discusses ESOPs as a means for a selling shareholder to exit the business, let's assume that the shares are sold to the ESOP by the selling shareholder (as opposed to being contributed by the shareholder or the company as an employee benefit). So where does the money come from to buy the shares?

The money used by the ESOP to purchase the selling shareholder's stock is most often borrowed from a commercial lender. The money can be borrowed by either the ESOP (using the stock as collateral) or the company (using the assets of the company as collateral). When the company borrows the money, it must then distribute the money to the ESOP to fund the purchase of the shares. For simplicity sake, the diagram in Figure A illustrates a scenario whereby the money is borrowed directly by the ESOP.

TAX ADVANTAGES OF SELLING TO AN ESOP

As noted in Figure A, there are several potential tax benefits when selling C-Corporation stock to an ESOP. The first major benefit is to the selling shareholder, who can defer the taxes due on the sale of the stock by reinvesting the proceeds from the sale in Qualified Replacement Properties (QRPs). Don't be misled by the name. The use of the term properties does not mean real estate. QRPs are essentially stocks, bonds, warrants or debentures of domestic corporations receiving not more than 25% of their income from passive investment (in other words, most US publicly traded companies). Mutual funds and real estate trusts do not qualify, however. The primary limitation on the Section 1042 Rollover is that the ESOP must own at least 30% of the company.

The second major tax benefit of an ESOP comes from the tax deductibility of the annual distributions made by the company to the ESOP for the purposes of repaying the ESOP loan. Therefore, unlike a traditional commercial loan made to a company, where only interest payments are tax deductible, the entire amount of the distribution to the ESOP is deductible by the company for federal income tax purposes. Again, there are certain limitations on this — primarily that the deductibility of the distribution made to pay principal on the ESOP loan is limited to 25% of the total payroll of the participants in the ESOP.

ADDITIONAL FACTORS WHEN CONSIDERING AN ESOP AS AN EXIT STRATEGY

With all of these apparent benefits, most business owners would ask, "Why wouldn't I consider an ESOP as an option?" Here are a few reasons why.

Lack of Liquidity and Ability to Exit Immediately

In most cases, the ESOP's ability to purchase stock from the selling shareholder will be limited by the company's ability to borrow money. For companies that already have a significant amount of debt on their balance sheet, this can be problematic. In order to borrow additional money to fund the ESOP's purchase of stock, the company must demonstrate to a lender that it can service its existing debt, in addition to the new debt being taken on to fund the purchase of shares by the ESOP. Even in the best of circumstances, when the company has no existing debt, its ability to borrow money will be limited based on its ability to service the debt. This inevitably means that the ESOP will have to purchase the shares in more than one block (e.g., 40% initially and the remainder over time, after the debt is substantially paid down).

By selling shares in blocks, over a number of years, the selling shareholder must continue to bear the "risk of ownership" until all of his/her shares are sold. While this might turn out to be beneficial if the company's value continues to rise, typically one of the primary goals of an exiting shareholder is to "lock-in" value to be able to exit the business without having to bear the ongoing risks associated with ownership of a privately held business. By retaining a substantial (often majority) ownership interest in the company, the selling shareholder retains much of the risk he/she was trying to "escape" by selling the stock.

Finally, to achieve the tax-deferred status of the sale of stock to an ESOP, the selling shareholder must be willing to reinvest the funds in QRPs, which means that the money will be tied up in other investments; investments that may carry more risk and less diversification than some investors are willing to bear, especially those heading into their retirement years. While this may be acceptable to some sellers, others will want to have access to some or all of the sale proceeds immediately in more "liquid" form (e.g., cash or cash equivalents).

No Room for Mistakes — Cash Flow Really is King

Transitioning ownership in a privately held business is never an easy process, and that process is made more difficult when the business must take on debt to complete the transition. If not managed properly (both the business and the debt), the management team can find itself spending more time managing their lenders, than managing the business. A slight down turn in the economy, the loss of a major customer, an unexpected increase in raw material costs - any one of these things can drive a heavily leveraged business into crisis mode in short order.

On the flip side, it also takes cash to grow a business. One of the intended consequences of selling to an ESOP is to create the additional incentive for employee/owners to act in a way that is in the best interest of the company. This often manifests itself in more rapid growth. In most businesses, especially asset intensive businesses like those in the industrial gas industry, it takes cash to grow. In addition to purchasing more fixed assets (trucks, cylinders, pallets), growing businesses use cash to fund increased levels of inventory and accounts receivable. While this is often viewed as a "good problem," these cash needs take away from the company's ability to distribute cash to the ESOP to pay down debt. If the company does not have the cash to fund these tax-deductible distributions, its taxable income, and therefore its corporate income taxes will be higher, thus exacerbating the problem.

An additional consideration in planning for the cash needs of a leveraged ESOP is the fact that the company (or ESOP) must be prepared to repurchase shares that are distributed from the ESOP to individuals that leave the company or reach retirement age. Depending on the terms of the ESOP, the repurchase of these shares may have to be made in a lump sum or could be made over time (but with interest). In either case, the company has an obligation to repurchase the shares. Should an extraordinary number of employees chose to exercise this option at the same time, it could create an unexpected drain on cash.

Finally, while relatively inexpensive when compared to the one-time transaction expenses of a third-party sale, the one-time and on-going expenses associated with establishing and maintaining an ESOP can add up over time. Depending on the scope and complexity of the plan, the fees for setting up and funding an ESOP could be $30,000 to $50,000 or more. Annual fees for administering and valuing the plan could be an additional $10,000-$20,000 per year. While not a significant amount of money for some companies, these expenses add up and take away cash that could otherwise go toward paying off debt.

A SIMPLE WAY TO LOOK AT IT

So what does all of this mean to the average business owner in the industrial, medical and specialty gas industry. As a means of "cutting to the chase," the financial model in Figure B compares three scenarios for a 100% shareholder to sell his or her ownership interest and exit the business.

Asset Sale to a Third-Party: The first scenario in Figure B demonstrates a sale of 100% of the assets of the company to a third-party buyer, which could include a private equity backed management buyout (see "The Management Buy-Out: Anatomy of a Deal" CGI October 2005). In an asset sale, which is what occurs most often in the industrial, medical and specialty gas industry, all of the assets (tangible and intangible) of the company are sold. Since we are dealing with a C-Corporation, there are two layers of taxation, corporate and shareholder. Assuming a purchase price of 5.75 times EBITDA (Earnings Before Interest Taxes Depreciation and Amortization), a basis in the assets of $3,924,800, and combined federal and state tax rates of 40% corporate (income) and 20% shareholder (capital gain), the seller would net $3,332,630 after paying off all taxes and corporate liabilities.

Stock Sale to a Third-Party: The second scenario in Figure B demonstrates a sale of 100% of the stock of the company to a third-party buyer. In this scenario, 100% of the stock is purchased from the selling shareholder for cash. The purchase multiple for a stock sale is assumed to be lower than that of an asset sale since the buyer will not have the ability to step-up the basis in the assets and "re-depreciate" them. Also note that the buyer is taking over the corporate liabilities in this scenario, which is essentially an addition to the purchase price of $1,172,771, since those liabilities will not have to be paid from the proceeds of the sale, like they would in an asset sale. Compensating for this lower multiple is the fact that there is no corporate level tax on the transaction since the stock is being purchased directly from the shareholder. Assuming there is no tax basis in the stock, this would create a capital gain for 100% of the proceeds. With a combined state and federal capital gains rate of 20%, this would yield after-tax proceeds to the seller of $3,495,549.

Stock Sale to a "Leveraged ESOP": The final scenario in Figure B demonstrates a sale of 100% of the stock to a Leveraged ESOP (i.e. an ESOP that must borrow the money to purchase the stock). To compare a best-case "apples to apples" scenario, the example assumes that the purchase price to the ESOP equals the after-tax proceeds of the asset sale to a third party. This assumes that the selling shareholder is willing to pass on all of his or her tax savings to the ESOP. Notwithstanding the fact that this would be very generous of the selling shareholder, it is a safe assumption only if the selling shareholder plans to reinvest all the proceeds in QRPs (thus making it a tax-deferred transaction).

Given that the ESOP must borrow money to acquire the stock, and it can only borrow an amount that can be serviced by the cash flow of the company, the purchase will most likely have to occur over a long period of time. To get a sense of how long, the scenario presented in Figure B estimates the cash flow that would be available to the ESOP to service debt used to purchase the stock.

In this example, after providing for annual capital purchases (CAPEX), corporate income taxes at 40% (mitigated somewhat by the tax deductible nature of the cash distributions to the ESOP), and a modest increase in working capital, the company (i.e. the ESOP) has approximately $421,000 available to pay fees of the ESOP, repurchase shares of stock, and service debt. Therefore, to achieve the equivalent after-tax proceeds as that of an asset sale ($3,332,630) using an interest rate of 5%, it would take over twelve years to complete the acquisition of 100% of the stock. If the selling shareholder is not willing to pass on all of the tax savings to the ESOP, that number increases to almost eighteen years. While this may be acceptable to some business owners, it is simply too long for most others.

ESOPS AND S-CORPORATIONS

A C-Corporation's profits are taxed separately from its owners under subchapter C of the Internal Revenue Code. An S-Corporation's profits are passed through to shareholders and taxed on their personal returns under subchapter S of the Internal Revenue Code. As noted previously, to get the full tax advantages of selling to an ESOP, the company's stock that is being sold must be a C-Corporation. According to the 2004 GAWDA profit report, over 50% of the companies reporting were not C-Corporations, but were S-Corporations, Limited Liability Companies (LLC) or partnerships. Whereas LLCs and Partnerships are completely excluded from using ESOPs, S-Corporation stock can be sold to an ESOP with certain tax benefits. These benefits are not nearly as significant as those of C-Corporations.

For example, the primary tax benefit to the selling shareholder is not applicable to S-Corporation ESOPs. Selling shareholders in S-Corporations do not qualify for the tax deferred rollover treatment that is afforded C-Corporation shareholders. This alone can make the difference in deciding whether or not to proceed with an ESOP as a means of transitioning 100% ownership of an S-Corporation. In the example in Figure B, this difference is represented, essentially, by the eighteen year pay out, as opposed to the twelve year pay out.

The second primary tax benefit of an ESOP (the ability for the company to deduct distributions made to the ESOP for the purposes of repaying the ESOP loan) is available to an S-Corporation ESOP, however in a slightly different form. As so-called "pass through" tax entities, S-Corporations do not pay corporate taxes; rather the taxable income of the corporation is "passed through" to the shareholders on a pro-rata basis. For ESOPs owning S-Corporation stock, no federal income tax is due on the ESOP's pro-rata share of taxable income.

The tax benefits available to an S-Corporation ESOP can still make it an attractive vehicle for accomplishing certain goals (employee retirement benefits, corporate finance strategies); however, for the purposes of considering a 100% stock sale and exit for the selling shareholder, the tax benefits are usually not significant enough to make it an advisable option.

Figure B
Financial Model Comparing Three Scenarios for a 100% Shareholder Sale to a Third Party vs. an ESOP

Income Statement	
Sales	$8,673,591
COGS	$4,414,858
Expenses	$3,538,825
Operating Income	$719,908
Interest Exp.	$8,674
Pre-Tax Income	$711,234
Corporate Tax	$284,494
Net Income	$426,740
EBITDA	
Operating Income	$719,908
Depreciation	$147,451
Owner Expense Adjustment	$225,000
Adjusted EBITDA	$1,092,359
Balance Sheet	
Assets	
Cash	$411,996
Inventory	$760,775
AR	$1,021,019
Fixed Assets	$4,000,000
Depreciation	-$1,856,994
Net Fixed Assets	$2,143,006
Total Assets	$4,336,796
Liab./Equity	
AP & OCL	$667,867
LOC	$69,389
Term Debt	$264,545
Equity	$3,334,996
Total Liab./Equity	$4,336,796

SALE OF 100% TO THIRD PARTY OR PE-MBO[1]

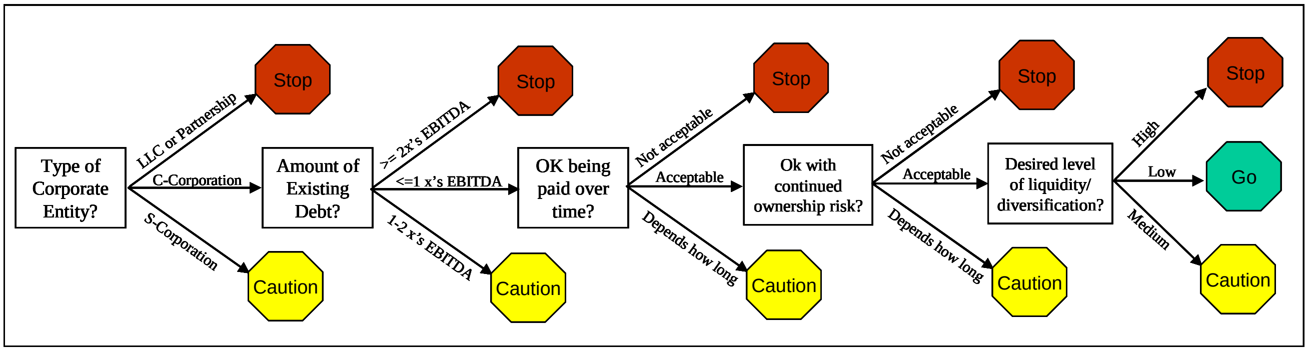
	Scenario 1 Asset Sale To Third Party	Scenario 2 Stock Sale To Third Party
Purchase Multiple	5.75	4.00
Purchase Price	$6,281,065	$4,369,436
Basis in Assets-Corporate	$3,924,800	
Taxable Gain-Corporate	$2,356,265	
Corporate Tax - 40%	-$942,506	
Corporate Liabilities[2]	-$1,172,771	
Gross to Shareholder	$4,165,788	$4,369,436
Shareholder Taxes — 20%	-$833,158	-$873,887
After-Tax Proceeds	$3,332,630	$3,495,549

SALE OF 100 % TO ESOP

	Scenario 3 Stock Sale to "Leveraged ESOP"
ESOP Cash Flow avail. to fund purchase	
Adjusted EDITDA	$1,092,359
Corporate Taxes[3]	-$268,427
Change in Working Capital[4]	-$55,696
CAPEX[5]	-$346,944
Available to distribute to ESOP	$421,292
Annual ESOP Fees	-$10,000
Reserve to repurchase shares	-$20,000
Debt Service on Existing Debt	-$16,697
Available to ESOP to service debt	$374,596
Years to fund purchase w/interest at	5.0%
@After-Tax Price (Asset Sale)	12.06
@Pre-Tax Price (Stock Sale)	17.94

1 PE- MBO = Private Equity backed Management Buy-Out
2 Includes approximately $300,000 of existing bank debt
3 Combined Tax Rate of 40% (Note: Distribution to ESOP is Tax Deductible)
4 5% Increase in Net Working Capital
5 4 % of Sales

Figure C



SUMMARY AND CONCLUSION

As you can see, there are some major potential benefits, but even bigger hurdles to a business owner in the industrial gas industry using an ESOP as a means of selling a 100% ownership interest and exiting the business. This article summarizes a few of the critical factors to consider when evaluating whether an ESOP is an advisable exit strategy. To help determine if it is worthwhile exploring this option further, the decision diagram shown in Figure C provides a series of questions and paths that can guide you in the decision making process.

The nature of the industrial, medical and specialty gas industry, which tends to be asset rich but cash starved, makes the option of using an ESOP to transition a 100% ownership interest somewhat limited. Achieving the desired results of a timely exit from the business, diversification of investments, and elimination of the "risks of ownership" are best achieved through some other means of transition. The use of ESOPs in the industry, however, can be an effective means of providing a retirement benefit to employees and/or generating growth capital, and we will address these topics in a future report.

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