Leveraged ESOP Transaction Insights

Leveraged ESOP Candidate Criteria Guidelines

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Introduction

This article is intended to provide a guide for company owners who have heard of, or who are considering, an ESOP formation transaction. This article is also intended as a guide for bankers, accountants, and others who may perceive the recommendation of an ESOP formation/company ownership transition transaction as a means of (1) achieving the wealth enhancement/diversification objectives of their clients and (2) providing the opportunity to offer additional professional services to their clients.

Individuals in the business of providing professional services related to the installation of leveraged ESOPs receive numerous calls from business owners. These business owners own companies of all types and sizes. Many business owners already have some limited information on the economic benefits of ESOP formation. Often, however, the business owners do not have enough information to make an informed decision on how a leveraged ESOP transaction would work in their particular company.

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The following discussion presents some of the attributes that distinguish a "good" ESOP company candidate. This discussion is based on our experience (1) as independent financial advisors to ESOP-owned companies and (2) as investment bankers in leveraged ESOP and closely held corporation sale transactions. As with any general discussion, there are many exceptions to the specific leveraged ESOP candidate criteria guidelines discussed herein.

ESOP Candidate Criteria 1: Need for Diversification

Closely held business owners or principal shareholders often have a need to diversify their personal portfolios. Typically, these individuals have spent most of their careers building their closely held businesses. However, these otherwise successful individuals have not adequately diversified their personal wealth. Often, virtually all of their personal wealth is tied up in the ownership of a substantial closely held corporation.

ESOP Candidate Criteria 2: Desire for Personal Retirement and Ownership Succession Planning

Closely held company shareholders (1) who want to begin the succession planning process or (2) who are nearing retirement age should know what ownership transition alternatives are available to them. For those shareholders who are interested in management and ownership continuity for their businesses, a leveraged ESOP transaction may be a viable alternative to the sale of the company to a third party.

Although many company owners do not begin the ownership continuity planning process as early as they should, a leveraged ESOP transaction can be an effective device for transitioning the company to the next generation of management and ownership. The key is to begin the ESOP formation planning process early so that the company ownership transition can be made on an orderly basis.

There are many examples of closely held business owners who have sold their shares to an ESOP—and then departed soon after the sale. Without enough time to adequately train and prepare the company successor management, a leveraged ESOP transaction may become a risky form of ownership transition.

ESOP Candidate Criteria 3: Business Cycle Considerations

A company (1) that has been in business for a number of years and (2) that has demonstrated an established market will make the best leveraged ESOP candidate. In addition, the successful leveraged ESOP candidate will be a company that is profitable and is experiencing continued growth. The more reliable the company's expected earnings stream, the less risk there is in an investment in the company.

A leveraged ESOP transaction in immature companies can be problematic. A premature sale of the company's stock to an ESOP may have to be at a much lower transaction value than the sale of a similarly sized company that has fully developed its markets and its products/services.

In the ownership transition planning process, business advisors recommending a leveraged ESOP transaction should carefully analyze what are the growth prospects for the company. If the value of the subject company is likely to increase significantly in the future, (1) a current sale of a small portion of the company or (2) a deferral of the sale to a later date may be the best alternative.

Alternatively, if the company is expected to continue its established growth pattern, then it may be the appropriate time for shareholders to receive the current fair value for their stock—without missing future large value increases.

ESOP Candidate Criteria 4: Company Size

Leveraged ESOPs are more common in large closely held corporations. For very small companies, ESOP transactions may not be practical. This is because there are relatively fixed administration costs related to the formation and maintenance of a leveraged ESOP.

The following discussion presents three "rules of thumb" regarding the minimum practical size for an ESOP formation transaction.

> *". . . there are relatively fixed administration costs related to the formation and maintenance of a leveraged ESOP."*

Number of Employees

There are no limits regarding how many employees a company must have in order to sponsor a leveraged ESOP. However, companies with fewer than 25 to 30 employees may find that the costs of installing a leveraged ESOP make such an ownership transition transaction economically impractical. There is also the issue of the payroll level amount required to support the required annual contributions to the ESOP plan. This issue is important because ERISA limits the amount of the annual contribution based on a percentage of employer corporation total payroll.

The National Center for Employee Ownership suggests that 20 may be an effective minimum number of employees required to economically sponsor a leveraged ESOP. Our experience suggests that 30 to 40 may be a more realistic "rule of thumb" regarding the minimum number of employees required to economically accomplish a leveraged ESOP transaction.

Annual Revenue

Of course, the guideline level for the profitability of companies varies greatly, even within the same industry. For this reason, using annual revenues as a guideline for ESOP suitability is not always a helpful rule of thumb. However, leveraged ESOPs are rare in companies with less than \$5 to \$6 million in annual revenues.

Profitability and Equity Value

In most cases, the value of a sponsor corporation's equity can be estimated based on a pricing multiple multiplied by the company's profitability. EBIT (earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation, and amortization) are commonly used measures of company profitability.

For example, let's assume that a company has an EBITDA level of \$1,000,000. Based on that EBITDA level, the enterprise value may be in the range of \$3.5 million to \$5.5 million (before subtracting interest-bearing debt). Subtracting interest-bearing debt would indicate the total equity value for the company.

A "rule of thumb" is that the equity value of a company should be at least \$5 million in order for a leveraged ESOP transaction to be economically efficient. A \$5 million total equity value would equate to a \$2.0 million price for a sale of a noncontrolling portion of the company stock.

ESOP Candidate Criteria 5: A Strategic Sale Value Not Critical to Sellers

As a general rule, when the closely held company shareholders recognize the need to be conservative in extracting value through a sale to a leveraged ESOP, the transaction is likely to go well. When the closely held company stockholders demand to obtain the absolute maximum value for their stock, a leveraged ESOP transaction is more likely to be unsuccessful.

Part of the leveraged ESOP planning process is post-transaction cash flow analysis. The sponsoring corporation and its financial advisor should carefully study the likely financial condition of the company in the years after the sale. Both (1) most likely and (2) worst case scenarios should be considered in this analysis.

> *"Part of the leveraged ESOP planning process is post-transaction cash flow analysis."*

The objective of this analysis is to ensure that the company:

1. will be able to amortize the leveraged ESOP debt safely and
2. will be able to react to unexpected business opportunities or contingencies as they arise.

ESOP Candidate Criteria 6: Successor Management

A strong leveraged ESOP candidate will have a senior management team (1) that has been on board for several years and (2) that is actively involved in the ESOP formation planning. Such a management team will alleviate the transition problems that often follow a sale of the principal shareholder's stock to an ESOP. In one recent ESOP transaction, our client had a senior management team that included eight executives: the president, CFO, purchasing manager, director of manufacturing, and the company facility managers. From the inception of the leveraged ESOP planning, these managers were actively involved in the process. After the ownership transition transaction was consummated, this management team was there to ensure that the ESOP-owned company would continue to be successful.

The sudden departure of a key shareholder/employee can have a disruptive effect on the closely held business. If the company founder, who may have developed most of the business relationships over the years, decides to suddenly sell the company to an ESOP, the business prospects can be imperiled.

ESOP financial advisors should be particularly sensitive to such key-person-dependent company transactions. This is because the ESOP's investment in a key-person-dependent company carries with it higher risk—and greater required returns. As a part of the sponsor corporation stock valuation process, the financial advisor will spend significant time talking to—and assessing the competency of—the management team.

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ESOP Candidate Criteria 7: Contingent Liabilities

The company's existing contingent liabilities should be discussed at the initial ESOP planning meeting. We have been involved in transactions where the employer corporation is, in almost all ways, a good ESOP candidate. Once we began our due diligence investigation as financial advisor to the ESOP, however, we uncovered significant contingent liabilities. These contingent liabilities invariably became a significant barrier to the leveraged ESOP transaction.

In one situation, a manufacturer of specialty chemical products asked us to analyze the financial feasibility of a leveraged ESOP. The company management had an idea of what the fair market value of the manufacturer was. Therefore, the closely held business owners had an idea of what a sale of the company to an ESOP would yield to the shareholders.

In fact, our estimated fair market value of the company on a capitalized earnings basis was within the range of what company management thought it should be. After additional analysis, however, we found that the manufacturer had a serious ground water contamination problem. This contingent liability (i.e., the environmental cleanup costs) turned out to be a deal breaker. In this case, there could have been no sale of the company to an ESOP without a full indemnification for the ESOP trust.

It is often better to delay the implementation of an ESOP until such contingent liability issues are resolved. This is because the ESOP trustee will be understandably concerned over an investment in a company with such unresolved problems.

ESOP Candidate Criteria 8: Openness to the Benefits of Broad-Based Ownership

Successful ESOP candidates tend to be companies where the senior management fully supports the concept of broad-based employee ownership. In companies where ESOP support only resides at lower management levels, communication of the ESOP benefits throughout the organization becomes difficult. And, the existence of the ESOP will not have the expected positive impact on the company results of operations.

ESOP Candidate Criteria 9: Available Collateral

Particularly with professional service firms, the issue of ESOP debt collateral is an important issue. Loan underwriting criteria with respect to ESOP loans is pretty much the same as for any other kind of commercial lending. The lender is looking for security in the form of loan collateral. And, the lender will look to the company for unencumbered assets to serve as such collateral.

The issue of ESOP debt collateral should be an early planning issue (1) for the company and (2) for the ESOP financial advisor. In the event there is insufficient loan collateral, the selling shareholders may have to support the ESOP loan with the transaction proceeds. In such circumstances, the selling shareholders continue to be at risk for the performance of the sponsor corporation.

Summary

The nine ESOP candidate criteria described in this article can serve as a simple checklist for closely held owners and for their advisors. Such individuals can use this checklist as they consider the difficult issues of (1) close corporation ownership transition and management succession and (2) the diversification/liquidity of owner's wealth accumulation in the closely held businesses.

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