Buyouts

GUEST ARTICLE

Leveraged ESOPs Provide Exit Opportunity

By David Waldstein, SES Advisors

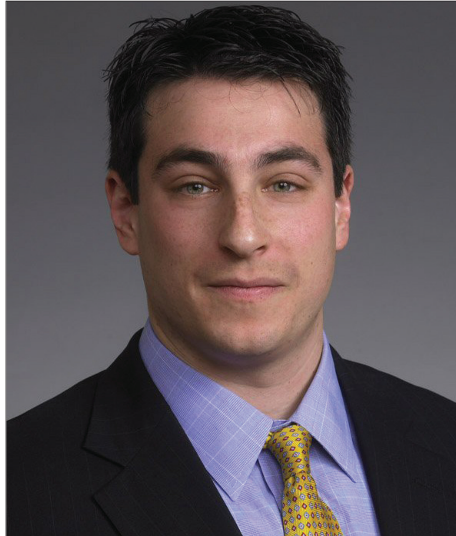
Frequently, portfolio companies have strong cash flows and strong management teams, but lack a clear exit strategy. In these situations, an IPO is often unlikely and interest from the M&A market may not look as promising as it was projected to be when the investment was made. As time passes without determining an appropriate exit strategy, these portfolio companies can begin to drag on the IRR of the fund. Fortunately for certain U.S.-based portfolio companies, leveraged Employee Stock Ownership Plans (ESOPs) can be an exit solution. In the right situation, an ESOP can be the best possible exit strategy for the fund's return, the company, the management team and the employee base.

Scott Hauncher of **Long Point Capital** has used the leveraged ESOP strategy to sell two companies: Sunbury Textile Mills was sold to an ESOP in March 2004 and Atlantic Plywood was sold to an ESOP in April 2008. In describing these companies, Hauncher said, "These were both companies that had very steady cash flows but were not rapidly growing businesses. This limited the potential to sell them for high multiples, but made them good credits for lenders." Hauncher went on to say, "We chose to exit through an S corporation ESOP because we realized that we could get the same valuation for the companies through an ESOP sale, and we would have control over the process."

Long Point Capital has had two successful exits through ESOP sales, but there are many other companies owned by private equity firms for which this strategy may be appropriate. As such, many other private equity firms across the United States have the opportunity to replicate the success enjoyed by Hauncher and Long Point Capital.

Tax Exemption

The highlight of the leveraged ESOP structure is that a 100 percent S corporation ESOP is exempt from federal income taxes. This tax exemption significantly increases a company's cash flow, shortens the payback period of the debt, and in turn, lowers the risk associated with the transaction and the company.



David Waldstein

Beyond the term of the transaction debt, the ESOP-owned firm continues to be tax exempt and becomes a cash cow making it more competitive in its markets. It has more money to invest internally to grow organically, or to invest externally to grow through acquisitions. Frequently, the first reaction to the leveraged ESOP from business owners is that the tax exemption is "too good to be true." However, that tax efficiency is reality. The ESOP is a qualified retirement plan, and therefore does not pay taxes. In a 100-percent ESOP-owned S corporation, the ESOP is the only shareholder. The S corporation passes its taxes through to the shareholders, and the only shareholder is a non-taxpayer. When owners realize the tax benefits are as advertised, their apprehension quickly turns to considering the possibilities that exist for a tax-free company.

What To Look For

There are several important company characteristics to consider when determining whether an ESOP is an appropriate transaction. First, a company becomes a good ESOP candidate when it consistently generates high quality cash flows, but is not growing at the rate that was expected at the time of the investment. This type of company can pay for the transaction, but may not be receiving as much interest from third-party buyers as was originally anticipated.

The second characteristic is a capable management team that is interested in participating in the buyout and running it on their own. In discussing the management teams of the two companies Long Point Capital sold to ESOPs, Hauncher said, "Both companies had experienced management teams, led by good people with whom we had worked for long periods of time. In neither situation did the management team request a sale to an ESOP; it was our idea. But when we explained the structure and opportunity to them, both management teams were very supportive."

The third characteristic is a company's annual tax burden. A company that pays a substantial amount of federal income taxes will see increased cash flow from the synergies realized from the ESOP transaction. This characteristic is important because it means that the company will have an increase in cash flow after the transaction is complete; cash flow that can be used for several purposes including assistance in paying for the transaction debt.

Seller Benefits

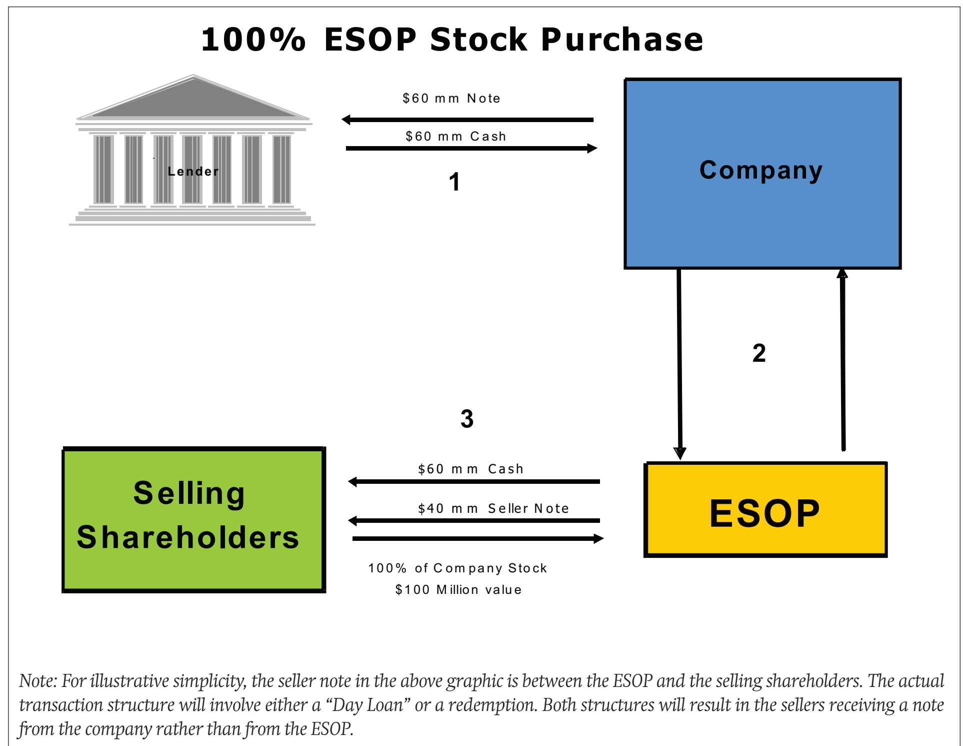
Clearly, the opportunity to effectively eliminate federal income taxes is a compelling reason to consider using an ESOP sale. However, there are seller benefits that may be enticing for private equity firms as well. ESOP transactions offer the seller the opportunity to control the sale process to a "friendly" buyer and make a good return.

An ESOP transaction is a sale to a friendly buyer because it is an inside deal. This means the transaction can require less due diligence and is associated with less risk because many of the players involved with the transaction already have extensive knowledge of the company. The players involved in getting the deal done are the sellers, the company's management team, the company's board of directors, the appointed trustee and the appraiser. Frequently, there is some overlap among the roles in the transaction, with the

only outsider being the appraiser. Common procedure calls for the seller to offer a price to the trustee that is representing the ESOP. While there is an opportunity for negotiation among the sellers and the trustee, ultimately the board will be controlled by the private equity firm (seller). Thus, pending sign-off from the appraiser, the sellers will control approval of the deal.

The return resulting from the sale to an ESOP is often enhanced by a higher rate of return, which is paid on a seller note. Seller notes in an ESOP transaction typically target 15 percent to 20 percent. This return is made up of two parts: a cash interest payment and warrants. It is common for the cash interest payment to be kept at a minimum, while the return generated from the warrants is maximized. This is done for two reasons. First, the cash interest payment is taxed as income, while the payment on the warrant is taxed as a capital gain. This makes the return from the warrant significantly more tax efficient. Second, the warrant allows the selling shareholders the opportunity to continue to participate in the upside potential of a company that will no longer be paying federal income taxes. In some publicly announced deals, the subordinated note included warrants worth as much as 40 percent of the outstanding shares of the company.

For a private equity firm, a high return from seller notes will not only provide a boost to the overall return on the investment, but will also make the ESOP a competitive buyer when other buyers exist. This point is significant when considering multiple offers at comparable prices. A private equity seller has more control over an ESOP transaction than over a sale to a third-party buyer. Therefore, at a comparable price, a sale to an ESOP should be desirable.



Note: For illustrative simplicity, the seller note in the above graphic is between the ESOP and the selling shareholders. The actual transaction structure will involve either a "Day Loan" or a redemption. Both structures will result in the sellers receiving a note from the company rather than from the ESOP.

Valuation Requirements

Valuation requirements make an ESOP transaction a viable exit strategy only in certain situations. ESOP purchases must be valued at no more than fair market value of the company stock. For publicly traded stock, fair market value is simply the most recent selling price. However, determining the value of non-publicly traded stock requires a valuation from an independent appraiser. The appraiser's valuation can be used in some instances to set the value of the transaction, and in other instances to assure that an arm's length negotiation has taken place. Often the appraiser is the only outsider involved in the ESOP process. For this reason, the transaction insiders need to make a convincing argument to the appraiser for why a particular selling price is appropriate.

Given the fair market value requirement for valuation, the ESOP transaction generally does not experience the premium that is seen in many IPOs or in M&A transactions. When a portfolio company can successfully generate a premium above fair market value, a leveraged ESOP will typically not be an appropriate exit strategy. However, warrants used in the financing of the deals can frequently make up a percentage of the premium that the leveraged ESOP transaction does not enjoy. When the company continues to generate excess returns while simultaneously repaying its debt, the warrants become more valuable than their intended return at the time of issuance. When this occurs, the gap between the company's fair market value and the premium generated in a third-party exit is reduced.

Conclusions

By using a leveraged ESOP, private equity firms have a viable, internal, ready-made exit strategy for a subset of their portfolio companies that would otherwise have a difficult time being sold. IPOs and acquisitions at high multiples will always be a preferred outcome, but they are not always available at the desired price. When this occurs, a leveraged ESOP offers private equity firms the opportunity to control the sale of their portfolio companies back to the employees who originally grew the company into a successful business.

The right type of business involves evidence of sufficient cash flows to satisfy the lenders' requirement to see the company's ability to repay its debt. A company that meets this qualification will become an even better candidate after the transaction because of the tax efficiencies the company will recognize. These tax efficiencies will lead to additional cash flows, which will first assist in paying for the transaction debt, and will then go towards growing the business. If management support and enthusiasm are factored into the equation, the result can be a successful transaction for all of the parties involved. ❖

David Waldstein joined SES Advisors in 2008 as an Associate in the firm's New Jersey office. Previously, he worked as an officer at State Street Corporation, Private Edge Group, developing and bringing to market the State Street Private Equity Fund Index. He was also a strategy consultant with the Swedish security systems company, Assa Abloy, where he did both strategic planning and acquisitions. Reach him at dwaldstein@sesadvisors.com

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