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ESOPs on the Rise

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Employees, no surprise, are often the most attuned party to a business's prospects. They're the first to know how well a company's products are being received and they're usually the best judge of a management team's capabilities. Yet, when it comes to seeking out potential buyers for a company, employees are often overlooked. Maybe they know *too* much.

Many market pros are anticipating that employee stock ownership plans (ESOPs) will become more common, however, as would-be buyers seek out financing alternatives in light of the crippled leveraged loan market.

"In today's tougher climate, where finding capital is more difficult, management teams are generally better able to judge levels of risk," says **Robert Satow**, a managing director at **Lincoln International**.

Perhaps the most heralded ESOP in recent memory was the Sam Zell-led taking-private acquisition of Tribune Co. in December. The company is now 100% owned by the ESOP. Other recent examples include Mitsui & Co.'s sale of Hannibal Industries, which was sold to an ESOP led by company president Blanton Bartlett. Lincoln was an adviser on that transaction.

The rise of the ESOP goes back to changes in the tax law in 1998 that allowed S-corporations to pursue these types of deals. Previously, only C-corporations were granted the right to execute ESOPs through the Tax Reform Act of 1986. In effect, an ESOP allows a company to avoid paying corporate income tax until there is a distribution to the owners of an S-corporation.

Initially, the tax and legislative changes were expected to yield more ESOP transactions, but specialists in the space note that only recently are they beginning to see more enthusiasm for the structure from dealmakers.

"It's a way to get a deal done in a recession, or at a time when financing is tight," says **David Ackerman**, a partner at law firm **Morgan Lewis**, who represented Sam Zell in his deal to buy Tribune.

He adds that in many cases ESOP-backed bids are competitive enough to surpass rival offers in a competitive situation.

From an operational perspective, it's also a common belief that ESOPs help align employee and company goals. Indeed, employees and management often rollover funds from their 401k accounts to reinvest in the business. With incentives in place, the theory goes, a workforce is more inclined to spend longer hours and more effort helping the company grow. The National

Center for Employee Ownership cited a study from Rutgers that found that ESOP-backed businesses showed 2.3% to 2.4% more sales growth than what would normally be expected.

Ackerman, meanwhile, anticipates seeing more deals similar in nature to the Tribune sale. "There are so many public companies that really ought to be private," he notes.

And since the Tribune deal, Ackerman says he has received more interest in the structure, and that his firm is currently engaged in a number of discussions with companies exploring ESOP transactions.

Bob Massengill, president of ESOP consultancy **SES Advisors**, also credits the Tribune deal with sparking interest throughout the market. "Investment bankers — guys I never met before — were calling me trying to figure out how ESOP deals are structured," he says. "There is a little bit of the herd mentality."

With that said, few expect to see a rush of ESOPs with the same scale exhibited in the Tribune buyout. And while private equity firms such as Yucaipa Cos. and Merit Capital Partners have used the structure successfully, not everyone believes PE firms will necessarily flock to the niche market.

"Private equity firms have not typically [pursued ESOPs], because they have to get comfortable not having over-50% ownership," Ackerman cites.

The more typical ESOP acquisition, according to Satow, involves privately owned companies ranging from \$50 million to \$500 million in size.

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