

**EMPLOYEE
OWNERSHIP
CONFERENCE 2016**



NCEO

NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP

MORE LIQUIDITY THE ROLE OF PRIVATE EQUITY IN ESOP TRANSACTIONS

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GILDED ROGUE

MORE LIQUIDITY – WHY ARE WE HERE?

- Many companies explore ESOPs and decline to pursue them because the ESOP transaction does not create sufficient liquidity.
- Private Equity can increase seller cash proceeds in an ESOP transaction, making the ESOP competitive with traditional private equity and third party sales.

WHY MIGHT AN OWNER EXPLORE LIQUIDITY OPTIONS ?

- **Exit Strategy Planning**
 - You want to diversify your assets and reduce the risk of having “all your eggs in one basket”
 - You want to preserve an ongoing role and maintain equity ownership in the Company
- **Retirement**
 - You are looking to sell the entire Company and retire
- **Family Succession**
 - You need to provide for liquidity for an older generation as part of an appropriate succession plan
- **Partner Buyout**
 - You need to generate the cash to repurchase the stock of a significant shareholder

WHAT ARE THE GOALS OF AN OWNER WHEN HE OR SHE EXPLORES A SALE TO AN ESOP?

- **Liquidity (Cash) & Wealth Diversification**
- Tax Minimization
- Management Team Incentive
- Employee Ownership
- Minimization of Culture Disruption
- Legacy for Owner
- Maintain Operating Control

WHAT ARE THE ALTERNATIVES TO AN ESOP?

- Hire an Investment Banker and
 - Sell to a Private Equity Firm
 - Sell to a Strategic Buyer

HOW DO THE ALTERNATIVES MEET THE GOALS

	Traditional ESOP	Private Equity	Strategic Buyer	ESOP + Private Equity
Up-Front Cash Liquidity	Light Green	Medium Green	Dark Green	Light Green
Tax Minimization	Dark Green	Light Green	Light Green	Dark Green
After-Tax Liquidity	Light Green	Medium Green	Medium Green	Dark Green
Management Incentive	Light Green	Dark Green	Light Green	Dark Green
Employee Ownership	Dark Green			Dark Green
Minimize Culture Disruption	Dark Green	Medium Green	Light Green	Light Green
Legacy for Owner	Dark Green	Medium Green	Light Green	Dark Green
Maintain Operating Control	Dark Green	Medium Green	Light Green	Light Green

SELL TO A TRADITIONALLY FINANCED ESOP

- What is it?
 - Cash is generated using only a senior loan from a bank
 - Owners receive proceeds consisting of cash and a seller note
 - Typical transaction split of value – 30% to 40% cash / 60% to 70% seller note
- Benefits
 - **The taxable gain can be reduced or eliminated if structured using IRC Section 1042, potentially eliminating a tax liability that could approach 35% of proceeds in CA**
 - Corporate taxes can be reduced or eliminated if structured as a 100% S-Corp structure or using certain ESOP loan structures
 - Incentives can be created through options and employee ownership and culture change is minimized
 - Control is maintained by the owner, if desired
- Issues
 - Significant wealth diversification is not achieved because of limited cash liquidity

\$100 MM Traditional ESOP

\$70 MM
Note Reinvestment

Cash Proceeds \$30 MM
After-Tax

SELL TO A PRIVATE EQUITY GROUP

- **What is it?**

- Cash is generated through an equity investment by the PE group and debt financing arranged by the PE group
- 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

- **Benefits**

- **More cash at closing** because of PE investment and additional debt financing generated by PE group
- 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

- **Issues**

- Tax Inefficient – Owners pay capital gains taxes / Company pays corporate taxes
- PE group will typically control the Company

\$100 MM Sale to a PE Group

\$20 MM Equity Reinvestment
\$24 MM Capital Gain Taxes
\$56 MM After-Tax Cash Proceeds

SELL TO A STRATEGIC BUYER

- **What is it?**
 - Strategic buyer, often competitor, pays cash or stock, if public
- **Positives**
 - **Potential for most pre-tax liquidity** if buyer attributes value to and pays for synergies
 - No further risk in company investment for existing owner
- **Issues**
 - Tax Inefficient – Owners will pay capital gains taxes on cash, potentially mitigating value of higher price
 - Elimination of owner upside in Company
 - Complete lack of control over future of business
 - Most potential for culture shock to management team and employees
 - Risk of release of competitive information through the sale process

**\$100 MM
Sale to a
Strategic
Buyer**

**\$30 MM
Capital Gains Taxes**

**\$70 MM
After-Tax Cash
Proceeds**

What is Private Equity and How Can It be Used in an ESOP?

- Private Equity is institutional capital used for investment in private companies with the goal of generating a risk-adjusted equity return
- Private Equity can provide additional liquidity to an owner in an ESOP transaction through an investment in the Company, which allows the owners to receive more cash and reinvest less in a seller note.

Private Equity 101 – Risk-Adjusted Return on Investment

- Investing - The Greater the Risk Taken, the Higher the Return Required
- Risk is Associated with:
 - Certainty of Cash Flow
 - Size of Company – the larger the company, the less the risk
 - Leverage – the less the debt, the less the risk
 - Industry Cyclicalities – the more stable the industry, the less the risk
 - Diversification – the more the diversification, the less the risk
 - Liquidity – the easier it is to sell the investment (e.g. public), the less the risk
 - Maturity – the longer the company has a track record, the less the risk
- Private Equity takes Risks
 - Typically invests in smaller private companies using equity and debt (highest risk profile)
 - Typically seek annual returns of 25% + on investments
- Valuation Multiples are based both on **risk** and on **growth** potential

Private Equity 101 – Objectives, Governance and Liquidity

- Objective – growth of equity investment value is paramount; that is how private equity professionals are paid
- Governance – active investors aligned with management
 - Active with management team to grow company
 - Alignment of Interests – management teams incentivized to create equity value
 - Control – If company is not performing, PE group must have ability to change team
- Liquidity – investment horizons typically 5 years, require ability to generate cash liquidity for PE investors, typically through sale of company

Private Equity in ESOPs – Tax Issues

- Most Tax Efficient ESOP Structure – 100% S-Corp. Structure
- But if the Equity of the Company is Owned 100% by an ESOP, how can a Private Equity firm invest?
- Synthetic Equity needs to be utilized
 - Consists of a Junior Debt Investment with an Equity Kicker (e.g. Options)
 - Designed to generate an investment return which mimics the return that would be generated through a traditional private equity transaction
- Complicated to structure and experienced tax advisors required to insure that all rules are met

Private Equity in ESOPs – Financing Issues

- 100% S-Corp ESOPs are 100% Debt Financed Companies
- Financing Consists of:
 - Senior Lender Debt – may be bank or non-bank lender
 - Structured Equity (Junior Debt)
 - Seller Notes (Junior Debt)
- Banks require the junior debt to be appropriately subordinated to the bank's senior debt
- Requires a sophisticated senior lender who understands the structure
- Investment by private equity may increase confidence of senior lender

Private Equity in ESOPs – Financing Benefits

- 100% S-Corp ESOPs generate significantly higher free cash flow due to the elimination of taxes.
- The higher free cash flow may allow the lender to:
 - Stretch and lend more to the company than it would lend to the same company that is a tax-payer, or
 - Provide more flexible rates and terms since the company should be perceived as a better credit.
- The higher free cash flow provides significant benefits to the Company, providing:
 - More capital for growth, and/or
 - More capital to deleverage rapidly, and/or
 - Current cash yield on the synthetic equity notes

Private Equity in ESOPs – Regulatory Issues

- Private Equity aligned with ESOP and Trustee primary objectives
 - 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 investments by the ESOP and the private equity firm
- Constraints
 - ESOPs are regulated by the Internal Revenue Code and ERISA, so careful adherence to IRC and ERISA rules is required

Private Equity in ESOPs – When Does it Work ?

- **When will a Private Equity Group (PEG) invest in an ESOP?**
 - The projected investment returns justify the risk
 - The returns are no less than the returns that would be generated in a traditional PEG purchase of the company
 - The PEG can create value and protect its investment through proper governance provisions
 - The PEG can structure its investment to meet the constraints imposed by the tax code and ERISA
 - The PEG can find sufficient debt financing for the transaction
- **If it works, it provides a new alternative**

NEW ALTERNATIVE: SELL TO A PE-BACKED ESOP

- **What is it?**

- Structured as a traditionally financed ESOP, but cash is generated through a synthetic equity investment (notes and options) by the PEG and bank loans arranged by the PE group
- Owners receive proceeds consisting of cash and synthetic equity (notes and options)
- Typical transaction split of value – 80% plus in cash, 20% in synthetic equity reinvestment (notes and options)

**\$100 MM
PE + ESOP
Transaction**

\$20 MM Structured
Equity Reinvestment

**\$80 MM
After-Tax Cash
Proceeds**

- **Positives**

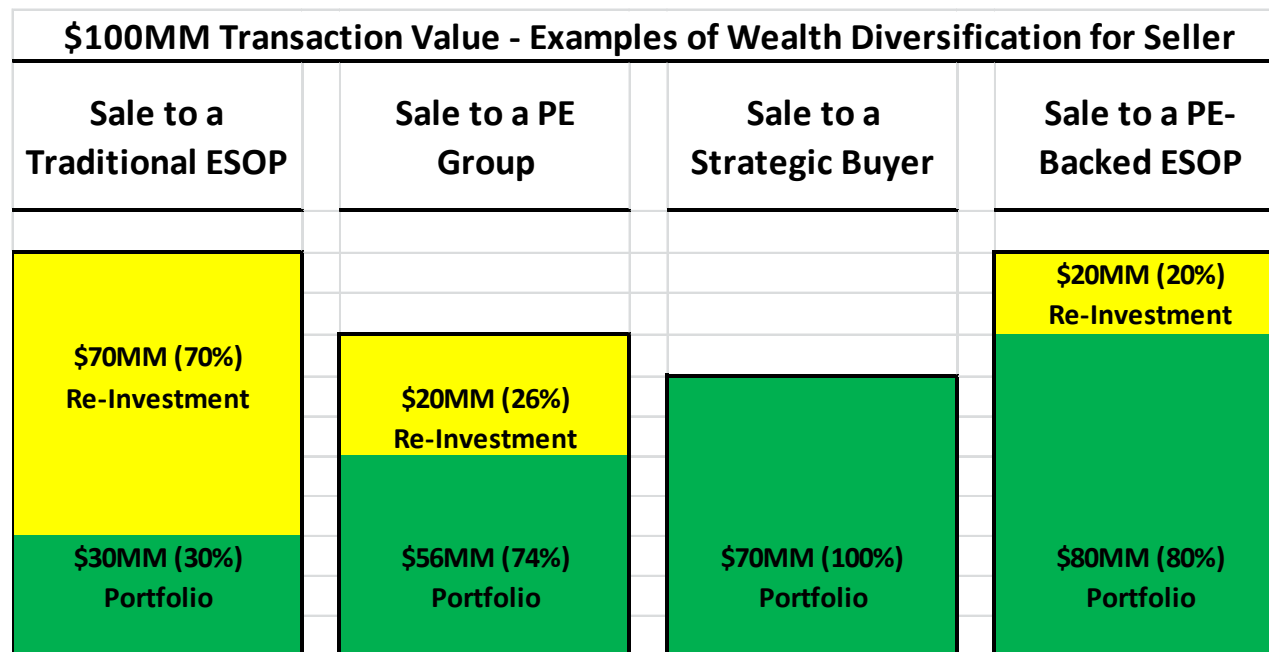
- **The taxable gain can be reduced or eliminated if structured through a IRC 1042 exchange, potentially eliminating a tax liability that could approach 35% of proceeds.** Corporate taxes can be reduced or eliminated if structured as a 100% S-Corp ESOP or alternative structures.
- **MOST AFTER-TAX LIQUIDITY** – more cash, less taxes
- PEG can provide significant value through additional expertise, relationships and capital
- PEG, owner and ESOP are aligned in desire for fair price and future equity value creation
- Maintain incentives through options and employee ownership

- **Issues**

- PEG will play important role in governance of the Company

PE-BACKED ESOP - MOST WEALTH DIVERSIFICATION

- Business owners often have 100% of their wealth tied to the success of one business
- Sale to a PE-Backed ESOP provides for greater total proceeds and potentially broader asset allocation than other liquidity options
- Sale to a PE-Backed ESOP allows an owner to retain a meaningful stake in the future performance of the business



Private Equity in ESOPs

What are the Obstacles?

- From the ESOP Advisor Side
 - Sophisticated M&A concepts - many traditional ESOP advisors have limited private equity and M&A experience and misunderstand how they apply to ESOPs.
 - Audit complexity - The concepts need to be effectively and succinctly communicable to the IRS and DOL in order to avoid misunderstandings and confusion during an audit.
- From the Private Equity Side
 - Sophisticated ESOP concepts – many PEGs and M&A advisors have limited understanding of ESOPs and the value of the structure
 - Myths and Misconceptions - many PEGs and M&A advisors have negative perceptions of ESOP transactions due to misinformation
 - Simpler is Better – complexity of ESOP structure, both from a tax and a regulatory point of view, make PEGs stay away

Private Equity in ESOPs

Conclusions

	Traditional ESOP	Private Equity	Strategic Buyer	ESOP + Private Equity
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