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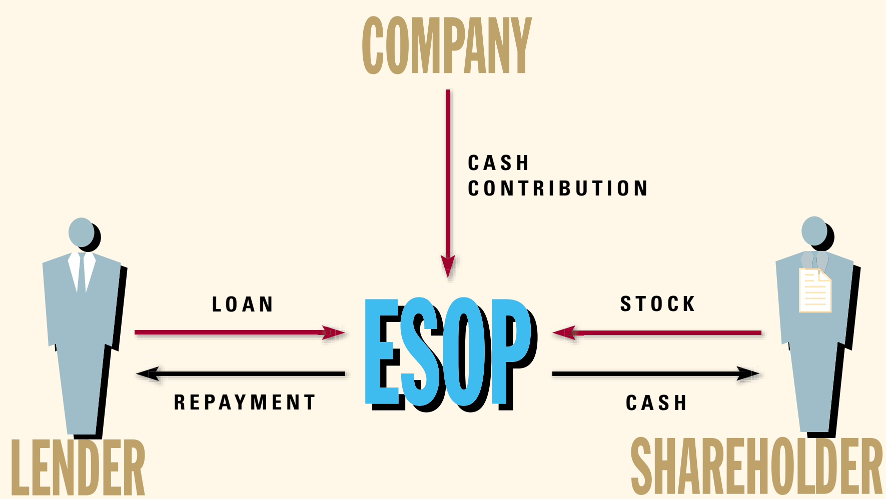
ESOP Myths and Realities

Contrary to popular opinion, an Employee Stock Ownership Plan is not a financial panacea.

by Frank S. Buhler

How a Leveraged ESOP Works

In a leveraged ESOP, the ESOP borrows money from a financial institution and uses the loan proceeds to fund the purchase of company stock from shareholders or the company.



When owners of privately held companies consider their ownership-transition options, invariably, the subject of an ESOP comes up. The popular press routinely touts ESOPs as having some mystical quality that defies the laws of economics, allowing sellers to achieve a value not otherwise obtainable. The truth is that the sale of a business to an ESOP is the optimal alternative in only a very narrow set of circumstances. Instead of being a panacea to the world of corporate finance, ESOPs are usually not the highest value alternative and can constrain the ability of many businesses to remain competitive in today's fast-paced marketplace.

WHAT IS AN ESOP?

An ESOP, or Employee Stock Ownership Plan, is a type of tax-qualified retirement plan that invests primarily in securities of the employer. Unlike other retirement plans, an ESOP has the ability to borrow money to purchase company stock; this plan is referred to as a leveraged ESOP. ESOPs are structured like profit-sharing plans that hold company stock in trust, which is then allocated to individual employee accounts, as they vest. At retirement or termination, employees have the

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ability to sell vested shares back to the ESOP or to the company. The proceeds can then be rolled over tax-free into an Individual Retirement Account ("IRA").

In its simplest form, an ESOP receives cash contributions directly from the company, which are then used to either purchase stock from the company or from selling shareholders. In the more complex leveraged ESOP, the ESOP borrows money from a financial institution and uses the loan proceeds to fund the purchase of company stock. As a practical matter, banks typically make ESOP loans to the company, which in turn lends the funds to the ESOP. As a result, the company's operating cash flow is the primary source of repayment. The company must also make contributions to the ESOP to pay plan expenses and to repurchase shares from departing ESOP participants.

WHAT'S IN IT FOR THE SELLING SHAREHOLDER?

The primary economic incentive for shareholders to sell to an ESOP is the deferral on the gain from the sale of shares. Once an ESOP owns 30%, selling shareholders can elect to reinvest the cash proceeds from the sale to the ESOP in qualified securities and thereby defer any capital gains tax until those securities are sold. If the securities remain in the estate after death, the beneficiaries get a "free" step-up in basis and eliminate the capital gains tax altogether.

Many prospective sellers interpret this tax deferral as receiving 25% more in after-tax proceeds than would be achieved in an equivalently priced taxable transaction.

> **In a more complex form of a leveraged ESOP, the ESOP borrows money from a financial institution and uses the loan proceeds to fund the purchase of company stock from shareholders or the company.**

And, while it is true that there has been a tax savings from the initial sale, until the ESOP repays the debt, the total amount of the seller's wealth actually declines.

Assume that a company with no debt and

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an enterprise value of $10 million borrows $3 million to purchase stock from selling shareholders. At the closing of that transaction, the selling shareholders' wealth declines

($ IN MILLIONS)	PRE-ESOP	POST-ESOP
Enterprise Value	10.0	10.0
Debt	—	(3.0)
Equity Value	10.0	7.0
Shareholder Ownership (%)	100.0	70.0
Shareholder Value	10.0	4.9
ESOP Sale Proceeds	—	3.0
Total Combined S/H Value	10.0	7.9

from $10 million to $7.9 million, as is illustrated above.

Over time, if the company generates sufficient cash flow to retire the ESOP debt (and otherwise maintains its value), this situation reverses itself.

In all but the most credit-worthy situations, lenders will require real security for the borrowing, which may include a pledge of sale proceeds or the seller's guarantee. The implication is that, although the seller may have "sold" the firm, he or she may remain at risk for its performance.

WHAT'S IN IT FOR THE COMPANY?

The benefit most often touted for leveraged ESOP companies is the tax deductibility of debt repayments. The fact is that the deduction is the same as any tax deduction that the company would otherwise receive for employee compensation.

A leveraged ESOP introduces new debt into a company's capital structure. Lenders evaluate the credit worthiness of such an enterprise no differently than they would a business that borrows for operating purposes. The difference is that borrowing for operating purposes typically creates new cash flows to service the debt, whereas borrowing to fund an ESOP extracts capital from the enterprise and encumbers existing cash flow. It is for this reason, that capital-intensive businesses and those that require meaningful investment to remain competitive are not good ESOP candidates.

ESOPs must also earmark corporate cash flow to fund participant share-redemption obligations. Under "normal" levels of attrition and retirement, this requires that a company "repurchase" itself about every eight to ten years.

WHAT'S IN IT FOR THE EMPLOYEES?

ESOPs can be a boon to employees if the ownership is provided in addition to regular benefits, essentially representing a non-compensated transfer of wealth from the prior owner to the employees. Because all of the retirement benefits are invested in a single, private security, ESOPs present a diversification dilemma. Regulations do, however, provide a diversification option for employees nearing retirement.

Clearly, ESOPs are not for everybody. The best candidates for ESOPs are companies where the preponderance of value is inherent in the human capital; and therefore, may be difficult to "sell" to a third party and those that do not have heavy capital investment requirements. Even if these particular characteristics fit your circumstances, a seller considering an ESOP should be prepared to remain close to the business for some time after a sale. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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