Zachary Scott
INVESTMENT BANKERS

INSIGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
SPRING 2008

Creativity + Timing = Opportunity

Taking another look at ESOPs.

by William S. Hanneman

Regardless of the claims by ESOP proponents concerning the relative performance advantages of ESOP-owned companies over their non-ESOP-owned brethren, readers of *Insight* know that we have not been enthusiastic advocates of ESOPs, except in special circumstances. Perhaps, that is because we are typically engaged by private business owners to achieve the highest value in the sale of a business and it is rare that an ESOP can justify paying the highest value, much less afford to do so. While there can be some meaningful economic incentives to the seller with a sale to an ESOP, those incentives are not typically sufficient to trump a strategic buyer's ability to justify paying the highest after-tax present value.

Economics aside, there are some circumstances in which a sale to an ESOP may make sense, either because there are no readily identifiable strategic buyers, or in situations where the preponderance of the value is inherent in the employees that are under no compulsion to remain after a sale, such as in personal services firms.

We were intrigued when one of the savviest investors of our time, Sam Zell, recently took the Tribune Company private using an ESOP. As a public company, the opportunity to purchase the company should have been open to all interested buyers, both strategic and financial. With no other media properties to combine with the Tribune Company, Zell was the quintessential financial buyer. We were curious why a financial buyer was apparently able to justify paying the highest value, and what Zell got out of the deal. In particular, we wondered whether there was something to learn from this transaction that would improve the position of ESOPs as an acquisition or corporate finance vehicle.

THE TRIBUNE COMPANY

With revenues of $5.5 billion and generating more than $1 billion dollars of operating income, the Tribune Company has its roots in print journalism. Over the years, it had branched out into virtually every aspect of modern media. It currently owns 11 daily newspapers, including the Chicago Tribune and the Los Angeles Times, approximately

We were intrigued when one of the savviest investors of our time, Sam Zell, recently took the Tribune Company private using an ESOP. As a public company, the opportunity to purchase the company should have been open to all interested buyers, both strategic and financial.

two dozen television and radio stations, as well as a number of investments in online media. In addition, the Tribune Company owns the Chicago Cubs and Wrigley Field.

Although a public company, the Tribune Company was effectively controlled by the Chandler family, which owned approximately 20% of the equity. An ESOP that had been established some years earlier also owned a portion of the stock. Prior to the Zell transaction, the company's revenues had been stagnating and operating profitability had been under pressure, primarily due to the challenging newspaper business.

THE TRANSACTION

The multi-step transaction was quite complicated. After cutting a deal with the Chandler family to support his offer, Zell purchased stock, loaned the company money, and arranged for additional debt that the company used to fund a redemption of its own shares. Because the stock was redeemed and not tendered to the ESOP, the traditional justification for using an ESOP did not apply. The sellers could not defer the capital gain by rolling the proceeds into qualifying replacement securities.

The redemption left the ESOP as the primary shareholder (along with management and Zell's investment company). Once the business was private, the company elected to be taxed as an S-corporation, therefore the company pays no federal income taxes on the approximately 92% of the business owned by the ESOP.

ESOPS have the unique status of not owing any federal income tax on S-corporation income; therefore if an ESOP owns 100% of an S-corporation, there is no federal income tax to be paid by either the S-corporation or its shareholder.

Having evaluated the transaction in some detail to determine if this structure could be used for the benefit of our clients, we think this transaction will be difficult to duplicate by companies in the middle market.

Unlike C-corporations, S-corporations do not pay income tax directly. Instead, income is passed through to the S-corporation owners, based on relative ownership, where it is taxed at each owner's personal tax rate. ESOPs have the unique status of not owing any federal income tax on S-corporation income; therefore if an ESOP owns 100% of an S-corporation, there is no federal income tax to be paid by either the S-corporation or its shareholder. The end result is that the funds that would have been used to pay taxes can be used for profitable corporate purposes.

In the case of the Tribune Company, the virtual elimination of federal income taxes greatly improved its debt service capacity. This incremental leverage allowed the ESOP to pay more for the business than other prospective

(continued p.2)

buyers were able to justify. Perhaps this was a fine result for the selling shareholders and may even be a fair result for the ESOP shareholders (although that remains to be seen), but what benefit did Zell derive from the deal?

When the dust settled, Zell, among other things, paid $90 million for a warrant that allows him to buy, over a 15-year period, up to 40% of the fully-diluted equity of the company for a total price of between $500- and $600-million. The warrant was structured to have an extended life so that it could be exercised after the 10-year period, after which the built-in gains created in converting to an S-corporation would expire, and was cleverly structured so that it was not deemed to be a second class of stock that is prohibited in an S-corporation. In the end, it is likely that Zell will never exercise his purchase rights. Rather, he ultimately will sell the warrant to the ESOP, or to other investors at the time of a public offering or sale of the company.

LESSONS FOR THE MIDDLE MARKET?

Having evaluated the transaction in some detail to determine if this structure could be used for the benefit of our clients, we think this transaction would be difficult to duplicate by companies in the middle market.

The Tribune Company transaction took advantage of a significant shareholder that was not happy with the performance of the business and was looking for a way out. The fundamentals of this business and its industry were not particularly attractive to most investors. Finally, the transaction clearly took advantage of the unusually aggressive financing conditions that existed prior to the crash of the credit markets.

While this transaction does not appear to provide any new corporate finance tools for middle-market transactions, ESOPs will remain interesting acquisition vehicles in situations where an owner does not require the highest value, is willing to sell interests over a period of time, or where no strategic buyer exists. ❖

Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

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.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Brian J. Kremen
206.838.5526
bkremen@zacharyscott.com