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Why Brokers and Investment Bankers Should be Thinking "ESOP"

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The past decade has been "nirvana" for the transactional community. Eight to ten times multiples were normal. All cash deals were common. Bank financing was plentiful and terms were lenient. Most of all, buyers were abundant and competitive, sellers were willing to consider most offers, and both sides were happy to pay a reasonable fee to get the deal done.

Over the past year, things have changed. Multiples are down. All cash deals are the exception. Bank financing is considerably more difficult to secure, and if secured, terms and rate can be onerous. The economy has punished bad or weak business models, and companies that cannot manage cash are out of business. One thing remains the same, however. Sellers are still willing to consider most any offer, and they will pay the fee if you can deliver.

As a result of the first wave of Baby Boomer retirements, we are seeing an all-time-high of owners seeking exit strategies. Statistics reveal that over half of closely held U.S. companies will transition in the next five years. Unfortunately, the current environment is making it tough for sellers to liquefy the value in their closely held companies via a traditional third party sale. Fortunately, however, there is another option.

ESOPs have historically represented about 7% of transition strategies while third party sales have represented about 60%. Today, owners surveyed by PricewaterhouseCoopers reveal that they are considering ESOPs nearly 20% of the time to transition their businesses, almost triple the historical level. What's driving this increase is macro economics 101, "supply and demand." Today, there are simply more owners who wish to sell than third parties who wish to buy. This phenomenon has created a very tough environment for investment bankers and business brokers who have become accustomed to healthy deal flow due to an excellent transactional market.

Simply, an ESOP is a qualified retirement plan that can act as a "willing buyer" for closely held stock. An ESOP differs from typical qualified plans in three ways: 1) ESOPs can borrow money 2) ESOPs are required to "invest" in the stock of the sponsoring company 3) ESOPs can engage in "transactions with parties in interest." Put these three things together, and the result is a retirement plan that can borrow money to buy stock from a selling shareholder. Not only can this strategy solve the problem of the current lack of third party buyers, it provides several key tax advantages for the seller (ability to get his proceeds tax free) and for the business (ability to pay for the transaction with pre-tax dollars). These tax benefits can reduce the cost of a leveraged transaction by more than 40%.

If you are experiencing a lack of buyers for companies that you have under engagement or that you have had under engagement in the recent past, then you should consider introducing your client to an ESOP for the following reasons:

- An ESOP can help the owner sell today
- An ESOP can pay full market value for an Owner's stock (we're seeing 4-6x)
- The Owner can execute a partial deal today, and then you can sell100% of the Company when the market returns
- An ESOP's tax advantages can enable the company's post-transaction value to return quicker than under a normal leveraged buyout/recap
- An ESOP can enable a company to cash-flow more debt than under normal circumstances due to the tax benefits

Candidates have the following criteria:

1. Corporation has unused debt capacity (not heavily in debt).
2. Corporation is profitable and can easily cash flow additional ESOP acquisition debt ($1M or greater in Adjusted EBITDA)
3. Corporation and/or its shareholders pay taxes at or near the top marginal bracket.
4. Corporation has been doing business successfully for at least five years.
5. Corporation has payroll of at least $1,000,000, excluding seller.
6. Corporation producing sales of at least $7,000,000 annually.
7. Corporation doing business in solid industry.
8. Majority shareholder interested in sharing equity ownership with employees in order to attract, retain and reward productive employees.
9. Corporation with strong secondary management capable of taking over and desiring to do so.
10. The ESOP will purchase at least $3M of the Corporation's stock from existing shareholders.

Executive Financial Services, Inc. is the preeminent Exit Planning and ESOP consulting firm in the MidSouth. We provide innovative solutions for closely held companies through a multi-disciplinary team of experienced, highly qualified professionals. Since 1981, EFS has established over 90 ESOPs throughout the U.S. ESOPs as exit strategies are quickly growing in popularity due to the significant tax advantages they offer for businesses and business owners who are seeking creative means to transition their companies. Over the next five years, approximately 50% of U.S. companies will transition. Therefore, if you have clients who are considering exiting their business or need to be considering exiting, we would appreciate the opportunity to work together. Don't lose a client by failing to introduce the concept of proactive Exit Planning. Many business owners sell out because they have not been exposed to strategies that can allow them to continue to run their business yet provide liquidity and diversification.

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