BCC ADVISERS

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Business Transfer & Valuation Information   VOLUME 15, ISSUE 2, 2018

Selling an ESOP-owned Company

There have been numerous studies outlining the benefits of selling a company to an employee stock ownership plan (ESOP). Whether it is securing the legacy of the business, improving employee retention and productivity, or tax benefits, there are a variety of reasons business owners use ESOPs as an exit strategy. The expectation upon establishing an ESOP is that it will last in perpetuity; however, circumstances can change and there could be instances when it makes sense to later consider selling to a third party. The following outlines some of the more common situations we see leading to a sale of an ESOP company.

in this issue

Repurchase or Debt Obligations
An ESOP, as a qualified retirement plan, primarily holds stock of the sponsoring company on behalf of the plan participants. Over time the sponsoring company or the ESOP will need to redeem shares for various reasons, including payouts for:

- Aging workforce that will be retiring or diversifying investments
- Employee terminations
- Employee death or disability

If a significant obligation is anticipated but the cash (or ability to finance the stock purchase) does not exist, it might be wise to explore selling to a third party for these capital needs.

Business Conditions Change
The dynamics of any industry change over time. New competitors come into play, product or service distribution methods change, and new risks and opportunities develop. No matter the type of corporate ownership structure, companies are left behind if they don't stay at the leading edge of changes or find ways to capitalize on new opportunities. The leverage of an ESOP may not allow a company to invest the required resources to keep pace with competitors, or a company may experience a decline in business that reduces employment levels to a point that an ESOP no longer makes sense.

Lack of Management Depth
One of the key factors of a successful ESOP is a strong management team that can both operate the business day-to-day and provide forward-looking leadership once the former owner exits. This remains true throughout the life of the business. If a company is not grooming a second level of management to transition into leadership roles when needed, the company may experience operational hiccups in the future. In addition, new leaders must continue to support employee ownership. Companies that do not have a natural successor for the CEO or president roles may find selling to a third party with these resources is the best course of action.

Non-ESOP Shareholders Exiting
It is not uncommon for an ESOP to hold a minority interest in the sponsoring company. Sometimes the ESOP will acquire 100% of the company over time; however, what if a non-ESOP shareholder wants to exit without selling more shares to the ESOP? In this case, an interested party could buyout both the non-ESOP shareholder and the ESOP.

Unsolicited Offer
Many companies use acquisitions to supplement organic growth. If your company

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business lines

By Steve Jacobs

Valuations are at levels we have not seen since 2007, and concerns are rising about the sustainability of the market and the amount of leverage being used to acquire middle market companies. Overall, now is a great time to be a seller and a challenging time to be a buyer. An M&A colleague recently made a baseball analogy regarding the current M&A markets – "Are we in the bottom of the eighth of a nine-inning game or will we be going into extra innings?" With the abundance of capital available it is hard to predict when this positive M&A environment will change as long as the economy stays strong, earnings remain robust, and interest rates stay moderate. The one thing history tells us is nothing lasts forever!

Given the positive M&A market for sellers, the following are just a few insights we provide our clients to help them avoid common pitfalls in the sale process.

Advisers

On the surface, selling a business may not seem like a difficult task; however, it is much more involved than simply identifying the buyer and agreeing on a price. Emotions can run high. There are management presentations to be made, purchase documents to be drafted by your legal counsel, and gathering of information for due diligence requests. All of this must be performed without taking your eye off the ball as it relates to your normal operations, and many times with limited assistance depending on who within your organization has been entrusted with knowledge of the sale. A strong advisory team can assist in making the process as smooth as possible.

Valuation Expectations

All business owners have a sense of pride in their companies, and rightly so. It takes years of time and effort to build and grow a strong organization. However, it is important to avoid letting this pride inflate your valuation expectations beyond realistic levels. The market will ultimately determine the value of your business, and by running a confidential auction process you ensure the market has an opportunity to define that highest valuation.

Confidentiality

Maintaining confidentiality is of the utmost importance during a sale. The fear of the unknown can cause employees to search for new jobs, strain vendor relationships, or allow competitors to take advantage of the news. Each of these can significantly affect the purchase price, terms, or the ultimate closing of a sale. Having an adviser serve as the intermediary between you and potential buyers provides greater confidentiality both internally and externally.

Timing

Selling on your own terms is always preferred over a forced sale due to financial troubles, health issues, or other reasons. Not only does a forced sale reduce your negotiating power, but you might also be ill-prepared to provide needed information or resolve any potential issues that come up. In addition, selling when you have the ability to remain involved under new ownership during a transition period will increase your odds of higher offers and a closed sale, as many buyers look to reduce their risk in this way.

Keeping these key points in mind when evaluating or moving forward with a sale of your business will allow you to avoid common headaches that can arise during the process.

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Selling an ESOP-owned Company *continued*

is on an acquirer's radar, you will likely receive an unsolicited offer. Although your company may not be on the market, it is important to carefully evaluate all offers to fulfill any fiduciary responsibilities to the ESOP. Leadership can decide if the offer should be countered or rejected, or if the company should run a process to evaluate interest from other prospective buyers.

These are just some of the reasons an ESOP-owned business might consider selling to a third party. In all scenarios there are many variables to consider before making a decision of this magnitude. Having a solid team of advisors with significant experience dealing with ESOPs can help you weigh the pros and cons of remaining an employee-owned company versus selling to a third party.

BCC Shares Expertise

BCC president **Steve Jacobs** shared his expertise at the **2018 Iowa M&A Conference** sponsored by the Faegre Baker Daniels law firm. Steve served on a panel of Midwest M&A experts discussing "M&A Market – A Potential Casualty of the Trade War?" As a member of the Alliance of International Corporate Advisors (AICA), Steve had the opportunity to share feedback from BCC's global colleagues as well as his own insights on what impact new trade policies may have on M&A.

This annual conference is offered for attendees to have the opportunity to network with hundreds of other transaction professionals and learn more about current activity in the Iowa deal community. It was held in Des Moines on September 8.

Acquisition Advantages for ESOPs

The creation of an employee stock ownership plan (ESOP) presents unique benefits and risks. There are entire books devoted to these subjects, but here we will briefly focus on two advantages for ESOP-owned companies when growing through acquisitions.

An ESOP in its simplest form is a tax-qualified retirement plan that invests in the stock of the sponsoring employer. It can hold all or any percentage of the company's stock, providing a beneficial ownership stake to all employees. In the mid-1990's, legislation was passed to allow ESOPs to own stock in S corporations. This opened up a significant tax advantage for ESOPs as they were no longer taxed on their share of profits from S corporations. **This advantage is especially attractive for an S corporation 100% owned by an ESOP, because the S corporation retains cash flow that would have been distributed to pay income taxes, thereby providing additional cash to invest into the business or in acquisitions.**

The second advantage relates to the financing of an acquisition. Generally, when a company incurs debt to finance an acquisition, only the interest payments on that debt are tax-deductible. **However, when an ESOP-owned company makes the same acquisition, both the interest amount and the principal payments may be deductible.** The result is that an ESOP-owned company generally has a much lower cost of capital making an acquisition than does a non-ESOP company. Theoretically this would enable an ESOP-owned company to pay a higher purchase price at the same cost, as shown in the table.

	ESOP Buyer	**Non-ESOP Buyer**
Purchase Price	**$20,000,000**	**$20,000,000**
Senior Debt	$10,000,000	$10,000,000
Tax Rate	30%	30%
Tax Savings from Principal Payments	**($3,000,000)**	**--**
Transaction Cost	**$17,000,000**	**$20,000,000**

The ability to use leverage and repay debt with non-taxed dollars is a substantial advantage that may allow an ESOP buyer to justify paying a higher purchase price in a competitive bidding process.

If an ESOP-owned company decides to acquire another company's stock directly, an independent appraisal and/or fairness opinion may be required or advisable. The degree of fiduciary involvement in the acquisition process is highly dependent on whether or not the ESOP is the majority shareholder of the purchasing company.

The opportunity to accelerate returns to the buyer, the potential for favorable tax treatment on sales proceeds, and the benefit to the employees of a target company who will become beneficiaries of the ESOP post-transaction all make the ESOP-owned company an attractive acquirer.

Making an acquisition is no small feat in and of itself. When an ESOP is involved in a transaction there are additional complexities that must be considered. Having an experienced advisory team in place to help you navigate through these hurdles is highly recommended to ensure a successful closing. **BCC has successfully advised ESOP companies on retained acquisition searches and has the added experience of providing dozens of business valuations annually for current ESOP companies and companies exploring employee ownership.**

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Evaluating Prospective Buyers

Making the decision to sell your business is a difficult task. However, once that decision is made there is still a significant amount of work to do before a sale is closed. For example, with assistance from your advisory team, you will need to gather the appropriate information to tell your company's story to potential buyers, evaluate the tax ramifications of a sale, negotiate a purchase price and terms, and eventually work through the due diligence process. **With such a significant investment of your time, it is important to go down this path with the right partner the first time.** Evaluating the following characteristics of a prospective buyer can help you become comfortable that you've made the right decision.

Financial Wherewithal
One of the most important considerations when researching prospective buyers is their capacity to fund a transaction. Looking at financial statements submitted to the Securities and Exchange Commission can accomplish this task for public companies. For private companies that are not required to publicly disclose this information, there are services available that estimate company sizes, but these are not always accurate. For this reason your advisor should request the appropriate information early in the process, including the prospective buyer's most recent balance sheet and income statement, or a commitment letter from their bank. In addition, buyers should outline their expected sources of financing and any related contingencies in their letters of intent.

Corporate Culture and Reputation
Business owners often credit their success to their team members. If you have instilled a corporate culture that resonates positively among your employees, you should desire to keep those employees that have helped get you to where you are today happy. Selling your business to a buyer with an unfavorable work environment and corporate culture can be devastating to your team's morale when the two companies are integrated.

Your advisory team should request references from team members of previously acquired companies in order to gauge how easy it was to work with management and whether management followed through with their promises. Ideally, you could reach out to the management or former owners of companies that performed well post-transaction and one that may have missed financial targets or experienced some other hurdle after being acquired.

Business Strategy
Although you will likely be giving up most, if not all, of the operational reigns to a new buyer, you may still have a vested interest in the success of the company through an earn-out, seller note or similar financing arrangement, and you certainly will be looking to preserve the legacy of your company. During initial discussions, asking questions to help you understand the integration and growth strategies a buyer anticipates implementing post-transaction will help establish your comfort level with the planned future of the business.

You are the ultimate decision maker when it comes time to sell your business. **Although prospective buyers will have a host of questions regarding your business, keep in mind that they are courting you. Just as they will ask questions of you, you should be comfortable interviewing them to ensure a successful transition and lasting legacy.** The list above can serve as a starting point, but every business owner has unique goals and may stress certain buyer attributes more than others. An experienced advisory team can help you navigate this process during this important period of your life.

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Some Recent BCC Advisers Transactions:

Advised an ESOP-owned insurance brokerage on a sale to a publicly-traded risk consulting services provider.

Advised a toy distributor on fair market valuation for a proposed transaction.

Prepared a fair market valuation of a machinery manufacturer for annual ESOP administration.

Provided valuation calculations for shareholder planning for an investment management company.

Prepared a fair market valuation to estimate the purchase price of a manufacturing company's assets for financial statement purposes.

Prepared a fair market valuation of a business process outsourcing company for management planning.

The Market Front

Some opportunities available through BCC Advisers:

Community bank - *is seeking a buyer.*

European-based contract manufacturer of stainless steel products - *is seeking a buyer.*

Roofing products distributor - *is seeking acquisitions.*

South American agribusiness specializing in soybean production - *is seeking a buyer.*

European consulting and cloud-based solutions provider - *is seeking a buyer.*