Overview of ESOP Transactions

Presented to

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Options for Business Owners

- Do Nothing
  - Keep running the company
- Do a leveraged recap
- Sell the business
  - To strategic or financial buyer
- Sell to an Employee Stock Ownership Plan (“ESOP”)

What is an ESOP?

An Employee Stock Ownership Plan ("ESOP") is:

> A tax-qualified retirement plan

> Designed to invest primarily in employer stock

> 11,500+ ESOPs covering over 10 million employees with $800 billion in assets

An ESOP Transaction is a sale of stock by the business owner to an ESOP for cash and/or notes, with substantial tax incentives

Who Are The Best ESOP Candidates?

- Owners interested in selling all or part of business
- Desire to gain liquidity, “lock-in” value and maximize returns in a gradual or “staged” sale of the company
- Private companies with a minimum of 20 employees, are profitable and with cash flow sufficient to service debt
- Established business history
- Limited exit options from strategic or financial buyers
- Sellers who want to retain operational control
- Non-highly leveraged balance sheet
- Have a capable succession management team
- Income taxes consuming cash flow

Why Sell to an ESOP?

> Highly flexible transaction; can be structured many ways to meet shareholder objectives
> Friendlier, more private process; less disruptive
> Allows business owners and existing management team to retain current operational roles
> Significant tax benefits to company and additional potential tax benefits to selling shareholders
> Provides meaningful ownership and retirement benefits to employees
> Retain independence and culture of company; leave a legacy
> Creates opportunity for liquidity, investment diversification, estate planning and ownership transition in a limited market for company
> Seller financing options can allow sellers to share in upside potential of stock

Valuation

ESOP sale price

- Negotiated between selling shareholders and ESOP Trustee
- Trustee can not pay more than “Fair Market Value”
- Determined by an Independent Appraisal

ESOP Tax Advantages

> Sellers:

Shareholders who sell stock to an ESOP may defer taxation (possibly permanently) on any gain resulting from a sale (1042 Rollover). Company must be a "C" corporation at time of sale.

> Company:

ESOP contributions effectively create income tax deductions for the repayment of principal and interest on the ESOP note– i.e. deducts transaction value over time.*

If the post-transaction company is or becomes an S-Corp in a 100% ESOP buyout, it is essentially tax-exempt.

*Note: In a C corp structure, the interest paid by the ESOP to the company is taxable income, but there is also an interest deduction on interest paid on the bank and seller notes.

Retain Upside and Operational Control

- Upside:
  - Can sell partial interest and retain upside on balance (S corp structure not recommended for partial ESOP sales)
  - Even if sell 100%, can have upside with warrants
- Control:
  - Sellers / current management can negotiate to retain operational control of company through Board of Directors

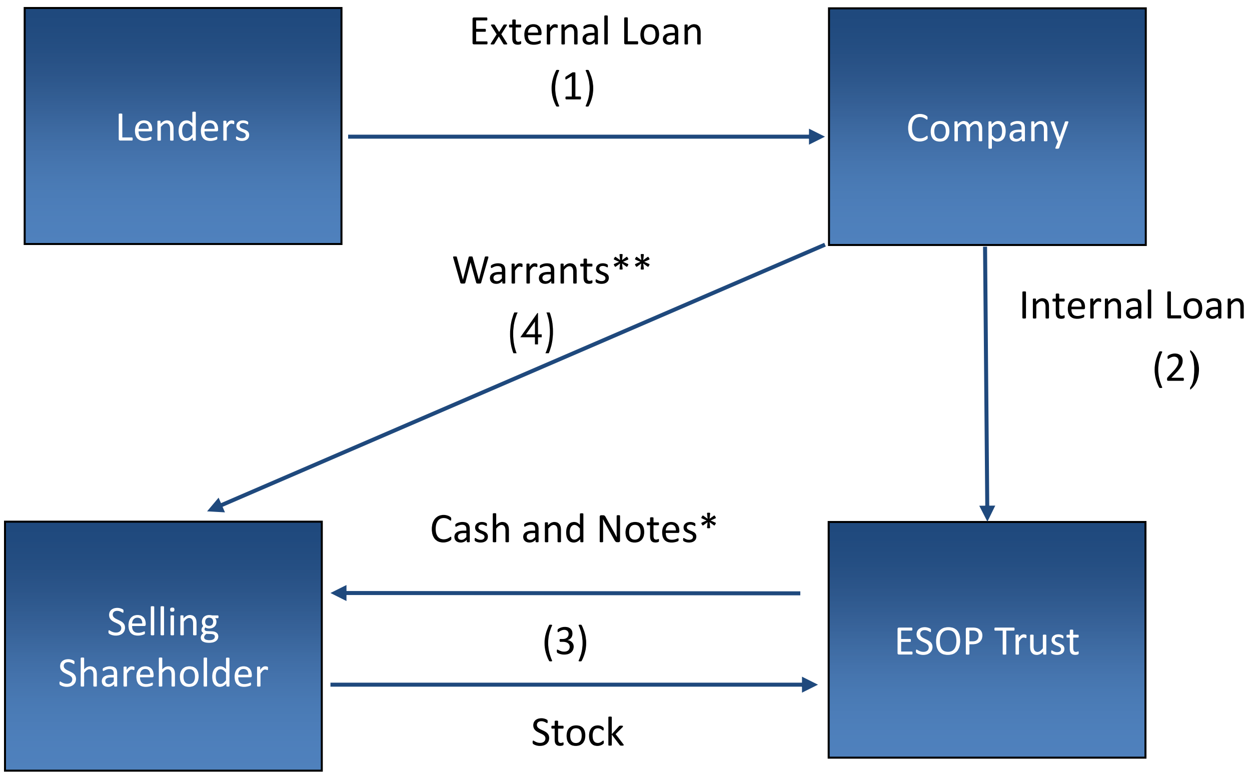
Benefits to Company

- Creates powerful retention and motivation tool by linking employee rewards to company performance
- Clear evidence of ESOPs outperforming non-ESOP companies (Rutgers Study)
- Can effectively deduct ESOP purchase price using ESOP contributions
- Increases after-tax cash flow and net income
- ESOP-owned companies are tax-efficient acquirers

Benefits to Employees

- Ability to build retirement wealth through company performance
- Stock in ESOP is allocated over time to employees
- Employer provided retirement benefit – no employee contributions
- “Key” Management can be rewarded with synthetic equity that tracks growth of company
- Tax-deferred employee benefits protected by ERISA

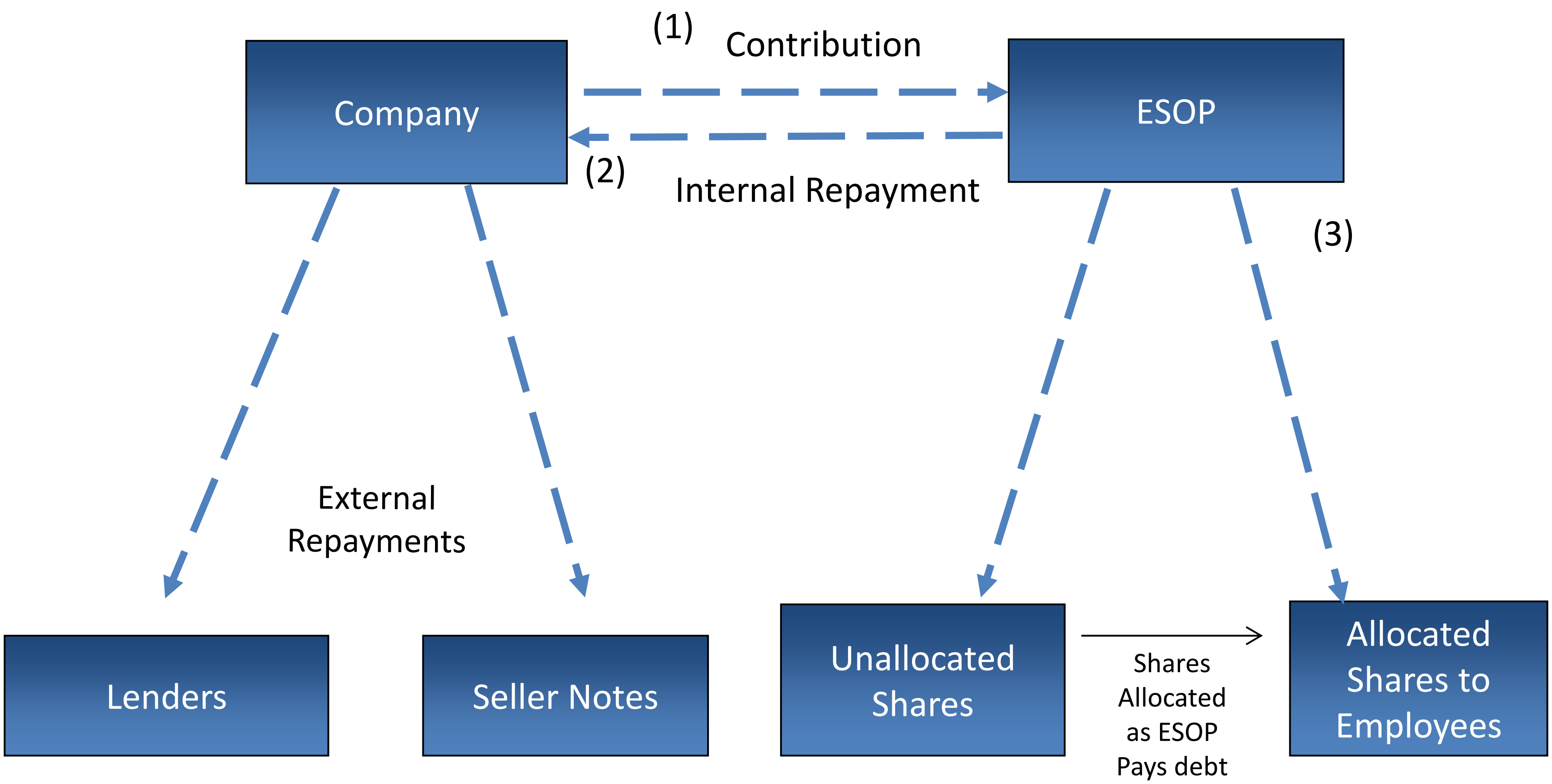
How Does it Work?



* Notes from ESOP typically refinanced by the company following the closing.

** Various structures can provide consideration for the issuance of Warrants.

Post Transaction Cash Flow



100% ESOP Sale Case Study

- Family-owned business
- Company had run prior sale "process" and had offers from private equity and strategic buyers
- Top family goals to achieve in a transaction
  - Maintain operational control of company until all sale proceeds received
  - Reward key mgmt and employees for dedication and loyalty
  - Minimize taxes from transaction
- Decided against selling the company to competitors but instead choose the 100% ESOP buyout

The ESOP Buyout Solution

The company (a “C” Corp.) was valued at $45MM:

> Financing was provided by $20 million of Senior Lending

> The selling shareholders received $20 million in cash, tax-deferred at closing

> The $25 million balance of the transaction was financed through junior subordinated notes and warrants held by the Sellers

> After closing, the company elected Subchapter “S” status

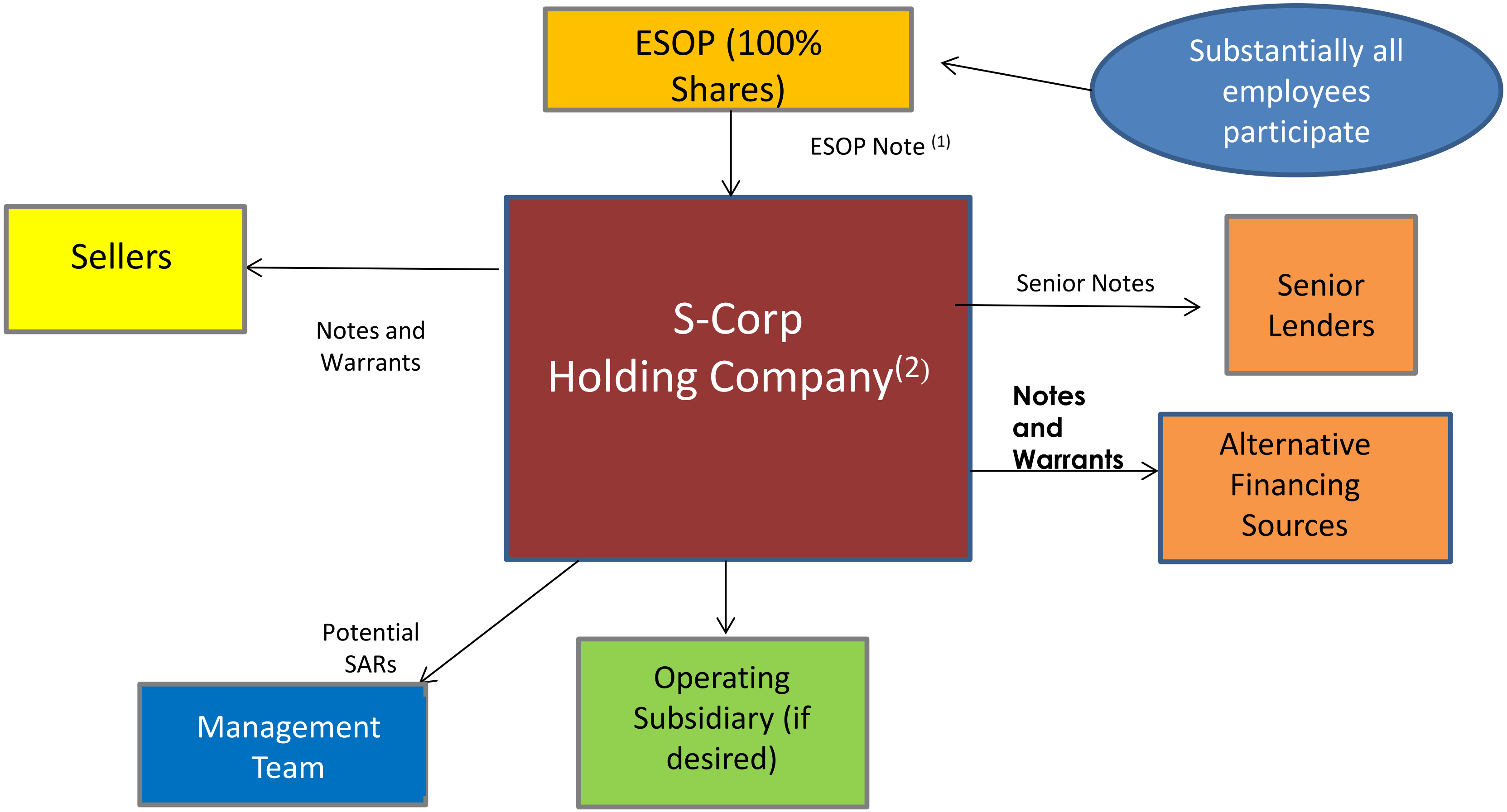
Why the EGOP Made Sense

Funds Received		Taxes Saved (adjusted for 2014)	
1. Sellers received cash at closing →	$20 MM		
	X	*Capital Gains Rate* Est. Fed = 23.8% State = 5% *	= $12.9 MM
Plus $25 MM Seller Notes →	$25 MM		
2. Company receives income tax savings (over time) = to purchase price →	$45 MM X	*Combined Corporate Tax Rate* Est. = 45%	= $20.2 MM

TOTAL TAX SAVINGS = $33.1 MM

* *Federal taxes may be reduced if state tax deduction is available*

Post Transaction Potential Structure



(1) ESOP pays not more than the fair market value of business – debt is deemed to be acquisition/purchase financing, as in any LBO.
(2) Restructuring matters may need to be considered to achieve S-Corp status.

Financing

- Senior Financing
- Mezzanine Financing
- Seller Note

Financing Resources

> Alternative Capital
Because of cash flow enhancements, lenders generally allow more leverage with ESOPs

> Senior debt: Banks and industry-focused finance companies

> Junior Debt
  - Sellers can take back “seller note” from company; company uses tax savings to pay note
  - If Sellers want maximum liquidity, can raise debt from mezzanine, equity co-investors and other traditional sources

Corporate Governance in an ESOP

- Board of Directors appoints the ESOP Trustee
- Board of Directors or ESOP Committee directs the Trustee on voting
  - Includes Board Nominees
- Trustee votes the stock
- ESOP Participants only vote their shares (pass-through vote) on:
  - Mergers or consolidations
  - Sale of assets
  - Recapitalization or reclassification
  - Liquidation or dissolution
- ESOP is a passive investor
- ERISA fiduciary duties apply

Process

- Key phases of ESOP Process
  - **Feasibility study** – includes preliminary valuation to set offer price
  - **Hire Seller Advisors**
  - **Design structure, obtain financing**
  - **Search for and hire independent Trustee**
  - **Trustee Hires Its Advisors** – counsel for trustee and trustee's financial advisor
  - **Trustee Due Diligence & Negotiation** – focus on business operations, financial performance and projections
  - **Close Transaction** – Trustee's financial advisor will perform valuation and deliver fairness opinion to Trustee at closing.
  - **Post-Closing** – ongoing corporate, tax and employee benefit work needed

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Jeffrey S. Kahn is a member of Greenberg Traurig's Global Benefits and Compensation Group and is Co-Chair of the firm's ESOP Practice Group. A member of the New York and Florida Bars and rated AV Preeminent by Martindale-Hubbell with more than 30 years of broad employee benefit experience, his practice focuses on retirement plans and the design and implementation of Employee Stock Ownership Plans (ESOPs). A noted speaker and author, Jeff frequently speaks before professional, charitable, financial, and business audiences on ERISA, ESOPs, and other employee benefit subjects. Jeff is listed in the 2010-2015 editions of *The Best Lawyers in America* in the category of Tax Law.

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