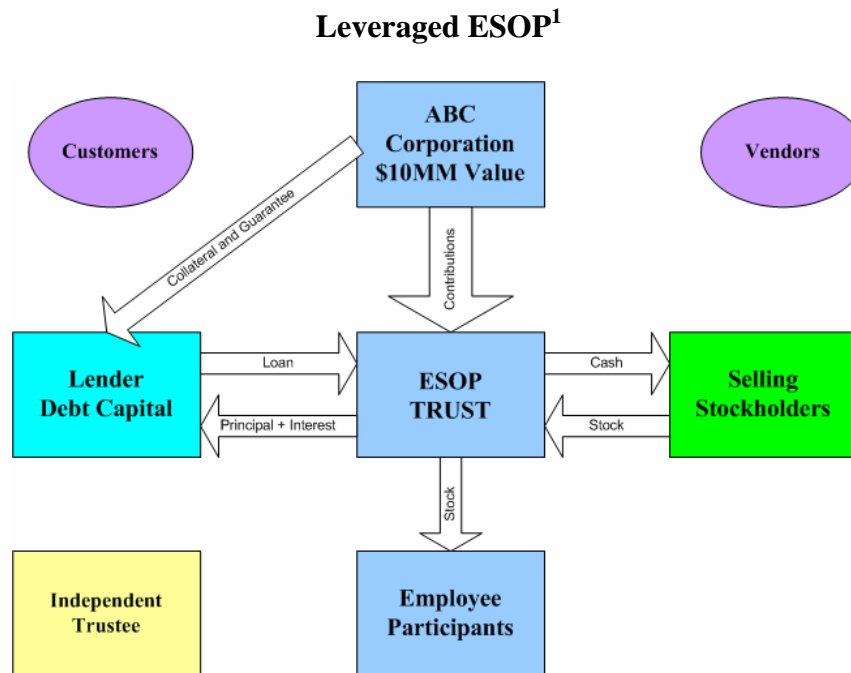


# WHAT EVERY CEO NEEDS TO KNOW ABOUT ESOP FINANCING

*“A White Paper on Leveraged ESOP Financing from Tucker Capital Advisors LLC”*

The leveraged (debt financed) Employee Stock Ownership Plan (ESOP) is one of the more difficult of corporate financings to fully understand and accomplish. Essentially, the selling shareholders leverage the company in the sale of their stock to the ESOP. Certain companies are ideal ESOP candidates, while others are wholly unsuitable. The successful ESOP will meet all of the goals and objectives of its stakeholders; namely its selling shareholders, management, employees, customers, vendors and banks. In other words, there are a lot of moving parts to ESOP financing.



For all of the parts to work well, certain criteria should be met first, or if not, should be considered as manageable limiting factors. Among them are –

- A mature business in an established market, experiencing continued growth.
- A financially stable company with predictable revenues and cash flows.
- A reasonably large company in revenues, number of employees and profitability.
- A company not particularly prone to changes in the business cycle.
- A senior management team that is actively involved in the ESOP planning.
- Employees who will value the opportunity to become owners.
- A balance sheet with sufficient collateral to support additional bank financing.
- A company that competes well in the marketplace.
- An owner willing to accept less than a strategic sale value.

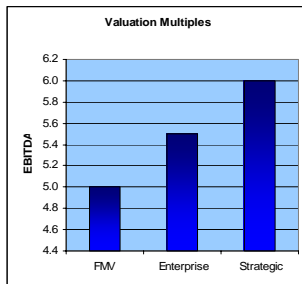
<sup>1</sup> ESOP structures may vary i.e. the ABC Corporation may be the borrower.

This does not mean that a hot, young software company is not a suitable candidate for an ESOP; it is just not as leverage-able. A construction company might not be suitable due to cyclical and so on. In many cases, there are favorable circumstances beyond these criteria.

The fundamental transaction is a leveraging of the company's assets and cash flow to purchase stock from the selling shareholders. The degree of leverage becomes critical to the ultimate success of the ESOP. Shareholders who sell 30% of their stock into the ESOP will incur a modest amount debt and be able to defer capital gains taxes on the sale. Shareholders who sell more and possibly contemplate a change of control transaction (majority interest) will incur considerably more debt. The degree of leverage is inter-dependent on five main issues as follows:

- 1. The Fair Market Value of the Company.**
- 2. A limitation on Contributions to the ESOP of 25% of payroll.**
- 3. The amount and percentage of shares to be sold.**
- 4. Willingness of a bank to leverage assets.**
- 5. Financial projections of the ESOP post transaction(s).**

### Fair Market Valuation



An ESOP must obtain a valuation opinion from an independent third-party valuation firm to determine the price that can be paid to the selling shareholders. The valuation is commissioned by the ESOP Trustee, who may also be the selling shareholder. Valuations are required annually. The standard of value for an ESOP is *fair market value* (FMV) as defined by the IRS<sup>2</sup>. FMV is not an “enterprise value” or “strategic sale value”. It is a reasonable, conservative value.

Selling shareholders must seek this seemingly lower value; however, they are often compensated with the other benefits of forming an ESOP. For purposes of this analysis, we will consider the ABC Company to have a FMV of \$10,000,000.

### Contribution Limitation

Contributions to an ESOP are the principal and interest with which the ESOP will retire its debt. These contributions are tax deductible and will save the company as much as 40% in taxes that would have normally been due. The contributions are limited to 25% of eligible payroll. This limitation is the maximum debt service that lenders can expect to be paid and may limit the amount of shares that can be sold at any one time.

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<sup>2</sup> IRS Revenue Ruling 59-60.

## Percentage of Shares to be Sold

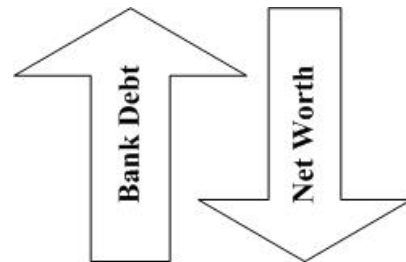
The selling shareholders may select any percentage of their stock to sell into the ESOP. However, in order to receive a deferment of capital gains they must sell at least 30%. We will assume that the amount of stock sold is between 30% and 100%. Implications of a change in control are ignored in this article. The value of the shares to be sold becomes the additional amount of debt or ESOP debt to be carried by the company.

## Bank Leverage

Most large banks provide ESOP financing on a regular basis and some even have special lending units. The mechanics of the loans to be made are not complicated; however, and banks of all sizes are capable of ESOP financing. What is complicated about this type of lending is understanding ESOP accounting<sup>3</sup> and the cash flow priorities in the post ESOP company.

Ordinarily, banks will define leverage as a ratio of “Debt to Tangible Net Worth” or some variant thereon.

In ESOP financing, where the contributions from the company to the ESOP are pre-tax cash flows, banks will be more lenient in the application of D:TNW ratios.



As the amount of ESOP debt increases the amount of net worth decreases and it is common that net worth becomes negative. In this case banks may require a second leverage ratio on cash flows expressed as “Debt to EBITDA<sup>4</sup>”. In the non-ESOP company this ratio might be a maximum of 3.0 to 1. But again, in the pre-tax cash flow environment of an ESOP, banks may become more aggressive and establish initial ratios as high as 4.5 or 6.0 to 1. The standard EBITDA to Debt Service requirements of 1.25 to 1 will apply, with the exception of the first year which may dip to 1.1 to 1.

## Financial Projections

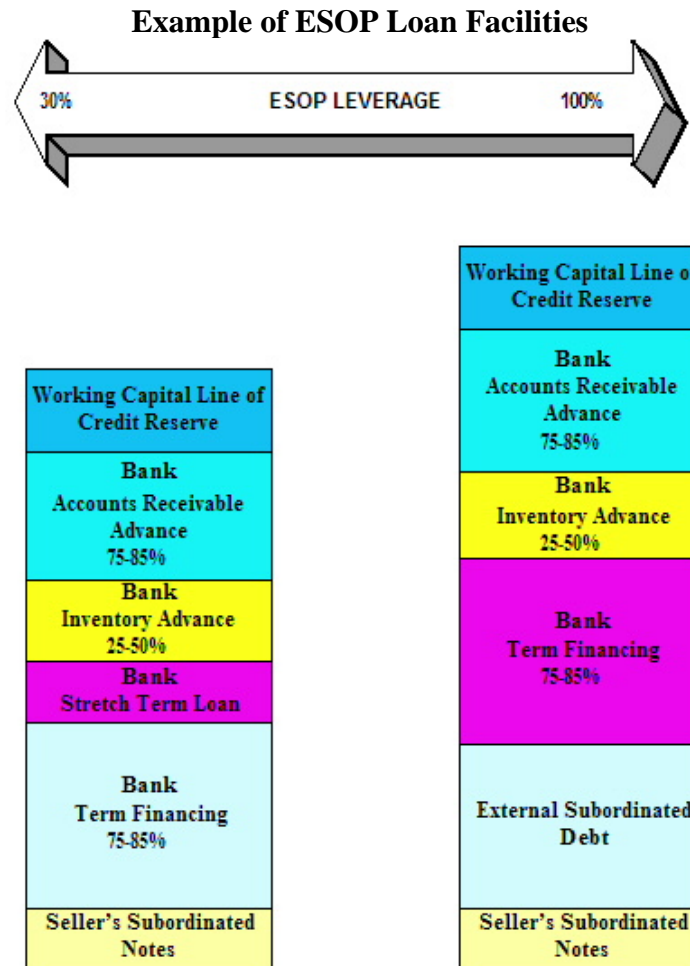
Banks will require a set of 5 year financial projections that support the contemplated loan transactions. Because of the peculiarities of ESOP accounting, it is highly recommended that an accounting firm be engaged to provide the needed projections. The transactions must also be prudent from a financial point of view. Young companies will often exhibit historical growth rates of 20% or more; however, in an ESOP transaction, such growth rates may be imprudent. Projections, above all, must be realistic and credible to all stakeholders concerned. Financial projections may also be required by the independent valuation firm as another method of valuation (discounted cash flow). Done carefully, projections can be a document in which all stakeholders can come to agreement.

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<sup>3</sup> ESOP accounting is beyond the scope of this article.

<sup>4</sup> EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization.

Financial projections allow banks to set appropriate financial ratio covenants in the subsequent years. These ratios should be closely scrutinized and discussed with the lender to avoid unintended technical defaults. New financial performance ratios should be formulated each year.



Loan facilities to ESOPs invariably are matched to the assets in amounts and maturities related to those assets. Each type of loan facility provides a particular amount of loan proceeds and requires a certain pay back period. Here are the various levels.

**Bank Revolving Credit**

In the example above, the Working Capital Line of Credit Reserve, Accounts Receivable Advance and Inventory Advance are all considered to be part of a Revolving Credit facility. Traditionally, revolving credit is for working capital purposes and is on a demand basis, but in the case of the ESOP in which the assets are leveraged to purchase stock, the revolving credit may have a maturity out to three years. The Working Capital

Line of Credit Reserve is an extremely important part of ESOP financing. This is a portion of the revolving credit which is not paid to the shareholders but instead is used only for the company's working capital needs. The determination of the amount of the reserve is discussed later.

### **Bank Stretch Term Loan**

The bank may make a "stretch" term loan without any specific collateral to support the credit. This type of loan is often made when the cash flow of the company is high relative to the collateral to support it. The loan relies on the total collateral base and cash flow. Sometimes, the loan is based on a multiple of EBITDA (perhaps 1 or 1.5 times). The stretch term loan is also called an "airball" and is usually required to be repaid within 12 to 24 months. Note that in the example of the 100% ESOP, there is no stretch loan because of the external financing provided by a subordinated debt lender.

### **Bank Term Financing**

Banks will generally lend 70-80% of fixed assets or "hard collateral". Equipment and real estate are appraised and the bank will make loans over the useful life of the collateral. Equipment may run 3-5 years and real estate as much as 20 years. While the collateral may support a very long term loan and a very low payment, most banks will limit their term commitments to 7 to 10 years. Because of the often large amount of debt, banks may require the ESOP to hedge the interest rates through SWAPs, so as not to have a rising floating interest rate disrupt debt service payments.

### **Seller's Subordinated Notes**

The selling shareholders can be lenders too. In our \$3,000,000 ESOP financing case, suppose the bank would only lend \$2,500,000. In this case, the selling shareholders would "take back" a note for \$500,000. In a variant on sellers as lenders, the bank may lend the full \$3,000,000 but require the selling shareholders to "pledge back" sufficient collateral to cover the \$500,000 over advance. The collateral to be pledged back is often in the form of bank deposits or high grade debt securities. Seller's notes are almost always subordinate to the bank loans in both repayment and priority. Notes are given installment treatment if the payments are regular and interest rates are usually higher than the bank rates. In the case of a 100% buyout at the \$10,000,000 level, the seller's subordinated notes may be quite large.

### **External Subordinated Debt**

In the larger example of a 100% ESOP (employee buyout), some additional external financing may be required. This is most often accomplished with mezzanine financing or subordinated debt. Subordinated debt is provided by large banks, Small Business Investment Corporations (SBICs) or insurance companies, depending upon the size of the transaction. There are a number of SBICs specializing in ESOP transactions. Sub-debt is expensive debt or cheap equity depending on your point of view. Selling shareholders

may be fully paid out with the use of sub-debt. Most often, this type of financing requires a relatively high interest rate and an equity position in the company in the form of warrants. Sub-debt is versatile and may involve interest only for a period of years followed by amortization over an additional number of years. Repayment may be expected from a refinance of the debt, a sale of the company or from earnings. The “all in” cost of sub-debt may be as low as 18% or as high as 30% dependent on the risk and terms involved. Selling shareholders may wish to participate in this debt financing vehicle.

## Conclusion

Employee buyouts (100%) are the least common ESOP formation. Something less than 100% (often 30%) as a first sale to the ESOP is the norm. Subsequent sales, as the company grows and becomes more valuable, allow selling shareholders to cash in at higher multiples later. This may be a longer than anticipated exit strategy for selling shareholders, but might also yield the very highest gain over time.

A key point to remember is the Working Capital Line of Credit Reserve (aka “dry powder”) in that the ESOP company is a net borrower of capital. Working capital can only be accessed through the line of credit, trade payables and of course new profits. Balancing the needs of the business (growth and profits) with the contributions to the ESOP can be difficult in down economies. A good rule would be “Don’t kill the goose”. Another good rule would be to maintain the reserve at the same level of net working capital before the ESOP transaction.

Creating an exit strategy through an ESOP is much the same as a Leveraged Buy-Out (LBO) in terms of leveraging the company. In the ESOP case, the selling shareholders remain in control of the cash flows and are not burdened with the quite different set of risks in the LBO model.

CEOs contemplating an ESOP will do well to consider the transaction as an “engineered” sale. Sellers can control almost every aspect of the transaction. The ESOP transaction is only limited by the amount of financing it can support, the requirement that an independent, qualified valuation firm be engaged by the ESOP Trustee, and that the ESOP pay no more than Fair Market Value.

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**Tucker Capital Advisors LLC is an investment banking and financial services advisory firm specializing in privately-held small and middle market companies. We provide our clients with transaction advisory services in buying, selling, valuing, financing and expanding their businesses. Contact: S. G. Brooke Tucker, Managing Director at 410-561-0699 or [brooke@tuckercapitaladvisors.com](mailto:brooke@tuckercapitaladvisors.com)**

