GBQ Consulting

VALUATION OBSERVATIONS

Do the Math: ESOPs Can Dramatically Increase Sellers' Proceeds

The advantages of employee stock ownership plans ("ESOPs") are well-documented, particularly from the viewpoints of employee-owner participants and the sponsoring company. However, many shareholders are reluctant to sell their shares to an ESOP because of their misconception, and perhaps the misconceptions of their professional advisors, that sales to ESOPs are not financially advantageous and that the seller is effectively "leaving money on the table" with this type of transaction. On the contrary, this article demonstrates that seller shareholders can often generate far higher net proceeds with an ESOP sale than with a traditional transaction, all without placing a detrimental financial burden on the company. In the example outlined below, which uses ordinary and reasonable transaction assumptions, the selling shareholder nets 46% more proceeds under the ESOP transaction than under an outright sale of the company.

Example

John Doe owns 100% of ABC Company ("ABC"), a company he started from scratch many years ago (his tax basis in ABC stock is essentially zero). John is contemplating a sale of 100% of his stock to a to-be-formed ESOP, and he would like to compare the financial implications of this transaction relative to an outright sale of the business. John is 50 years old and he would like to remain with the company for another ten years.

ABC is a debt-free S corporation that manufactures widgets and generates $2.0 million of earnings before interest, taxes, depreciation, and amortization ("EBITDA") annually. A highly qualified independent valuation firm has conducted an analysis and has rendered an opinion that the ESOP ABC is a debt-free S corporation that manufactures widgets and generates $2.0 million of earnings before interest, taxes, depreciation, and amortization ("EBITDA") annually. A highly qualified independent valuation firm has conducted an analysis and has rendered an opinion that the ESOP could pay up to $10 million for this stock without paying more than "adequate consideration" (or "fair market value"), representing an EBITDA multiple of 5.0x.

Assumptions for Example	
Company Assumptions:	
EBITDA	$ 2,000,000
Debt	-
Enterprise Value	10,000,000
Total Payroll	3,000,000
Enterprise Value Growth Rate	5.0%
Selling Shareholder Assumptions:	
Tax Basis in Stock	$ -
Selling Shareholder Salary	200,000
Ordinary Income Tax Rate	40%
Capital Gains Tax Rate	20%
Opportunity Cost of Capital	5.0%
Bank Loan Assumptions:	
Amount of Bank Debt	3,000,000
Interest Rate	7.0%
Term of Loan (years)	5.0
Shareholder Loan Assumptions:	
Amount of Seller Financing	7,000,000
Interest Rate	8.0%
Term of Loan (years)	10.0
Term of Interest-Only Payments	5.0

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Given the difficulties in the banking industry, ABC is only able to raise $3.0 million (1.50x EBITDA) in bank financing, with a five-year term loan and an interest rate of 7%. To finance the remainder of the transaction, the seller agrees to accept a ten-year subordinated note bearing interest at 8% (i.e., slightly higher than the bank interest rate to reflect the higher risk, but certainly not in excess of a fair rate). The note requires interest-only payments until the bank loan is repaid, with principal payments for the following five years.

John has agreed to remain with the company for the next ten years, and he would be eligible to participate in the ESOP.

Financial Implications of Transaction

Although this transaction structure does not result in the seller receiving cash equal to the full value of the stock upon sale, John still benefits from four distinct cash flow streams received during and after the sale:

- **Sale Proceeds.** On the transaction date, John will receive $3.0 million of proceeds (i.e., the bank financing), which would be taxed as a capital gain (at an assumed rate of 20%) since John sold stock to the newly formed ESOP.
- **Principal Payments on Subordinated Debt.** Payments for the remaining $7.0 million of the purchase price will be paid in years 6 through 10, once the senior bank debt is repaid. The principal payments will also be taxed at capital gains tax rates since they are part of the original purchase price for the stock.
- **Interest on Subordinated Debt.** John will collect interest payments on the subordinated note of $560,000 annually for five years, after which time the interest payments will decline as the principal is repaid. This interest will be taxed at ordinary income tax rates (assumed to be 40%).
- **Sale of ESOP stock.** Lastly, once John is ready to retire after year 10, he will receive cash equal to the fair market value of the ABC shares he accumulated in the ESOP when he sells them back to the company or the ESOP (which will be taxed at ordinary income tax rates). We estimate the value of these shares based on John's percentage of total payroll (which is a proxy for the percentage of shares he will own in the ESOP) and the assumed growth rate in enterprise value of 5%.

  Considering these four payment streams and John's opportunity cost of capital of 5% (i.e., the rate of return he expects to earn on his investment assets), the net present value of the after-tax proceeds from this ESOP transaction would be approximately $8.8 million (see the accompanying table).

Comparison to an Outright Sale

Assuming an asset sale that would be fully taxable at ordinary income tax rates (since the vast majority of all sales of middle market, privately held companies are asset sales), John would have to achieve a gross sales price of $14.6 million, a 46% higher price than the $10 million sale price to the ESOP, to net the same $8.8 million of net after-tax proceeds available through the ESOP transaction (see the accompanying table). Stated differently, in this example, John would receive net proceeds from the ESOP transaction that were 46% higher than in an outright sale of the company. While we acknowledge that certain strategic buyers may be able to pay a higher price for a company than a financial buyer such as an ESOP, a 46% premium in value is an unquestionably high bar for a strategic buyer to hurdle.

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Summary

The illustration above, which uses market multiples, lending terms, deal structures, and rates of return that are common in today's marketplace, demonstrates the significant advantage of a sale to an ESOP from the perspective of the selling shareholder (a 46% advantage in this example). Moreover, the benefits of selling a company to an ESOP extend far beyond the potential for higher shareholder proceeds. Other benefits include: maintaining the company's legacy as an independent entity, rewarding the employees who helped build the company (by giving them the opportunity to own the company, and by preserving their jobs), and motivating a workforce that now consists of employee-owners. ESOP transactions can be complex and ESOPs are not always the best solution, but we strongly recommend that business owners and their professional advisors evaluate this option before committing to a sale of a business. GBQ has one of the largest ESOP valuation and consulting practices in the Midwest and we would welcome the opportunity to discuss an ESOP with you or your client.

Shareholder Proceeds - Outright Sale (in 000s)

Enterprise Value / Sale Price	$14,610
Less Shareholder Basis	0
Taxable Gain	14,610
Ordinary Income Tax	5,844
Net Proceeds	**$8,766**
Required Premium in Sale Price	*46.1%*

Shareholder Proceeds - ESOP Transaction (in 000s)

Year	Deal Proceeds	Seller Interest	Seller Principal	Sale of ESOP Stock	Gross Proceeds	Ordinary Inc. Tax	Capital Gains Tax	Net Proceeds	PV of Net Proceeds
Year 0	$3,000	$0	$0	$0	$3,000	$0	$600	$2,400	$2,400
Year 1	0	560	0	0	560	224	0	336	320
Year 2	0	560	0	0	560	224	0	336	305
Year 3	0	560	0	0	560	224	0	336	290
Year 4	0	560	0	0	560	224	0	336	276
Year 5	0	560	0	0	560	224	0	336	263
Year 6	0	560	1,193	0	1,753	224	239	1,291	963
Year 7	0	465	1,289	0	1,753	186	258	1,310	931
Year 8	0	361	1,392	0	1,753	145	278	1,330	900
Year 9	0	250	1,503	0	1,753	100	301	1,353	872
Year 10	0	130	1,623	1,086	2,839	486	325	2,028	1,245
Total	**$3,000**	**$4,566**	**$7,000**	**$1,086**	**$15,652**	**$2,261**	**$2,000**	**$11,391**	**$8,766**

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