An Introduction to ESOPs

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TheCorporateCounsel.net

LAZEAR
CAPITAL PARTNERS

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Creating Value through Strategic Thinking

ESOP Advisory - Management Buyouts

Sell Side Engagements - Capital Raising - Recapitalizations

Turnaround Advisory - Merchant Banking

OUR EXPERIENCE

Founded in 1999 and headquartered in Columbus, OH

OUR FOCUS

Mid-market companies with sales ranging from $25M - $500M

OUR ORGANIZATION

Diverse range of experts on staff (Attorneys, CPAs, CEOs, CFA, ABV, Commercial Bankers, & MBAs)

Columbus | Cleveland | Detroit

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Successful Transactions

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Northern Tree Service, Inc. 100% ESOP	Romanoff Group 100% ESOP	Kwest Group 100% ESOP	Weaver Custom Homes 100% ESOP	Ryba Marine Construction Co. 100% ESOP
Chapel Since 1946 100% ESOP	Beacon electrical contractors 100% ESOP	Easling Construction 100% ESOP	KBR Kelley Brothers Roofing, Inc. 100% ESOP	CCE Capital City Electric LLC 100% ESOP
UTI Utility Technologies International Corporation 100% ESOP	Arborwell Employee-Owned Tree Management 100% ESOP	ASI 100% ESOP	Atlas Industrial Contractors M&A	Decker Construction Co. Partner Buyout
Chemcote A business built on quality, reliability and service. 100% ESOP	Bandit Industries, Inc. 100% ESOP	Hercules Industries 100% ESOP	F&S Mechanical 100% ESOP	Flyers Pizza & Subs 100% ESOP
West Camp 100% ESOP	ATP Advanced Technology Products 100% ESOP	MarshBerry 100% ESOP	Pinnacle Plastic Products 100% ESOP	Polaris Automation 100% ESOP
FST Logistics Since 1991 100% ESOP	Kovatch Castings 100% ESOP	Lyon Video 100% ESOP	Best 100% ESOP	Zink Foodservice 100% ESOP

The ESOP Alternative

ESOPs are defined contribution plans that invest primarily in employer stock and are governed by The Employer Retirement Income Security Act (ERISA) of 1974.

- *Intent was to create ownership and retirement assets for working-class Americans*
- *Subject to DOL and IRS regulation and compliance*

1 An ESOP is an Ownership Transition Tool

- ESOP Trust is a single shareholder
- Creates ownership-minded culture

2 An ESOP is an Employee Retirement Plan

- Qualified retirement plan, non-discriminatory, tax-deferred growth
- ESOP Trustee acts as a plan fiduciary
- Company buys out employees when they retire or leave

3 An ESOP is a Tax-Efficient Leveraged Buy-Out

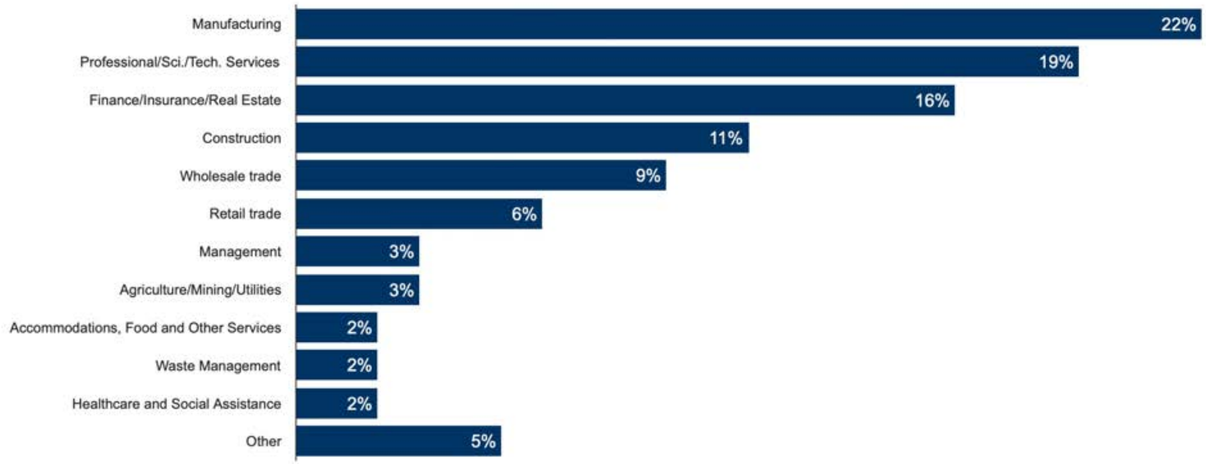
- Tax deferral on the gain is available to Sellers following a conversion from an S-Corp to a C-Corp prior to ESOP transaction
- 100% S-Corp ESOPs do not pay Federal or most State taxes, allowing expedited repayment of debt

ESOPs by the Numbers

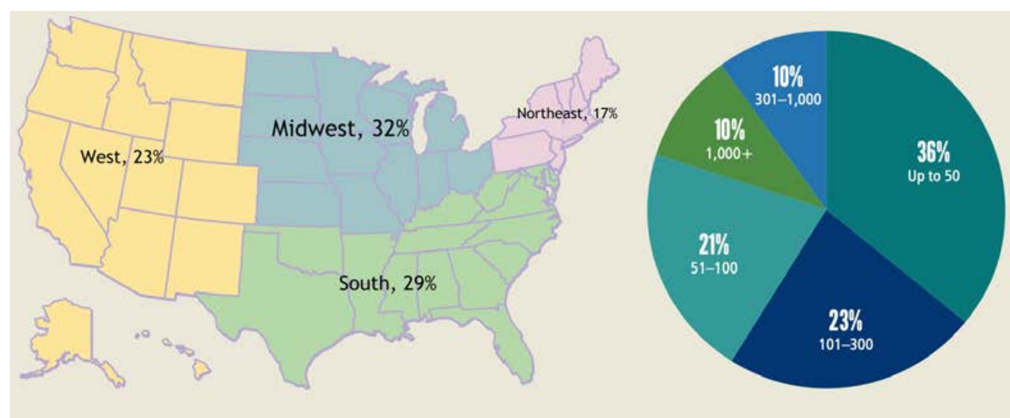
Currently there are almost 7,000 ESOP plans in the U.S.

- The National Center for Employee Ownership ("NCEO") estimates that approximately 28 million employees participate in employee ownership plans
    - Overall, employees now control about 8% of corporate equity
- ESOPs are widely distributed by both industry vertical and geographic region
    - Contractors and manufacturers comprise approximately 50% of our ESOP practice
- ~ 80% of all ESOPs are in Companies with < 300 employees

ESOP Distribution by Industry Vertical



ESOP Distribution Region and Participant Size



Source: NCEO

ESOP Economic Contribution

Employee Ownership Correlates to Enterprise Strength

Research studies show broad-based employee ownership results in more stable enterprises and significantly enhanced employee wealth

Stronger Companies

- ✓ 2% higher sales and employment
- ✓ 4-5% productivity increase the year an ESOP is adopted
- ✓ ESOP companies are twice as likely to remain in business as non-ESOP companies
- ✓ Employee-owners less likely to report being laid off (9.5% for all working adults vs. 1.3% for employee-owners)

Source: nceo.org

Significantly Enhanced Employee Wealth

- ✓ ESOP employees have a 5-12% higher median wage than non-ESOP employees
- ✓ ESOP employees have 20% more financial assets than non-ESOP employees, including 220% more in retirement plan assets
- ✓ Economic circumstances for ages 28 to 34 with employee ownership vs. peers without enjoy:
  - ~ 92% higher median household wealth
  - ~ 33% higher income from wages
  - ~ 53% longer median job tenure

Sample ESOP Design

Eligibility — One-year anniversary, 21-years or older, and at least 1,000 hours worked *(statutory maximum)*

Allocation of Shares — Shares to be allocated over a 30-year period +/-
(Subject to negotiation with Trustee as well as analysis of forecasted payroll trends)

Employee Accounts — Based on % of total compensation
(Can also use a points system that incorporates compensation and years of service)

Vesting

One Year Anniversary	0%
Two Year Anniversary	20%
Three Year Anniversary	40%
Four Year Anniversary	60%
Five Year Anniversary	80%
Six Year Anniversary	100%

(Six-year graded, and three-year cliff vesting represent the statutory maximum)

Distributions — Death, Disability, Retirement: Five-year pay out

Other Termination: Five-year waiting period, followed by five-year pay out.

Forfeitures — Reallocated to eligible participants at plan's year-end

Valuation — Conducted annually by an independent third-party appraiser

Top 3 ESOP Myths

I won't get a fair/competitive price

- By law, ESOPs can pay "Fair Market Value"
- In many cases, ESOPs can ***maximize Net After-Tax Cash*** to shareholders
- Seller-owned Real Estate is "protected"
- Buyer/ESOP pays all closing costs and deal fees

It takes "forever" to get my seller note paid

- The seller typically receives +/- 30% of the value in cash at closing
- Most seller notes are ***completely paid out*** between 4 – 6 years via periodic refinances
- If a company stumbles or underperforms, repayment can be pushed out, BUT
- The seller note continues to accrue an attractive return of +/- 12%

I have to report to a Trustee and will lose "control"

- The Trustee has no interest, ability or inclination to run the business
- Trustee's role is that of a fiduciary to ensure company follows plan documents
- Operational control remains with the seller and existing management – the same as previously
- Employee owners do not have any more rights; they can be fired

Sellers Alternatives

Objective	Sale to Third-Party	Sale to ESOP
Maximize Value	FMV determined by market	FMV negotiated with Trustee
Taxation of Gain [1] (Federal & State)	~ 25 – 35%	~ 0-25%
Liquidity & Payout	Upfront plus contingent	Upfront plus fixed
Predictability	Unpredictable	Predictable
Flexibility	Less Flexible	More Flexible
Likelihood of Close	Unknown	~ 100%
Disruption to Operations	Material *(Buyer access to employees & customers)*	Minimum *(Specialized Deal Team)*
Due Diligence Process	Multiple buyers, detailed	One buyer, streamlined
Escrows, Reps & Warranties	Onerous	Less contentious, straightforward negotiation
Employee Impact	Unknown	Positive
Post-Close Involvement	Buyer's discretion	Flexible
Does Plan Meet Objectives?	TBD	TBD

1. *For discussion purposes. Taxes represent an estimate. Please consult with your tax advisor..*

Benefits of an ESOP for the Seller *and* the Company

Selling Shareholder Benefits

- Can be structured as a tax-deferred or tax-free sale
- Includes a significant amount of (tax-free) cash at closing, plus a very attractively priced seller note
- In many cases, ESOPs can ***maximize Net After-Tax Cash*** to shareholders
- Seller-owned Real Estate is "protected"
- Buyer/ESOP pays all closing costs and deal fees

Tax Savings For the Company

- Company may be Federal and State tax-free post-ESOP transaction
- Use increased cash flow to pay off shareholders more quickly and fund growth

Corporate Governance

- Seller maintains operational control of the Company
- Preserve and sustain the legacy, history and culture of the Company
- ESOP companies typically outperform their peers/competitors

Key Manager Benefits

- Ability to realize significant economic benefits without any personal investment
  - SARs and participation in the ESOP create significant value
- Rewards of ownership without the risk – no personal guarantees

Incentivize Management and Employees

- Creates a valuable incentive for key employees
- Creates large retirement savings for all employees
- Preserves jobs and serves as a strong Recruitment and Retention tool

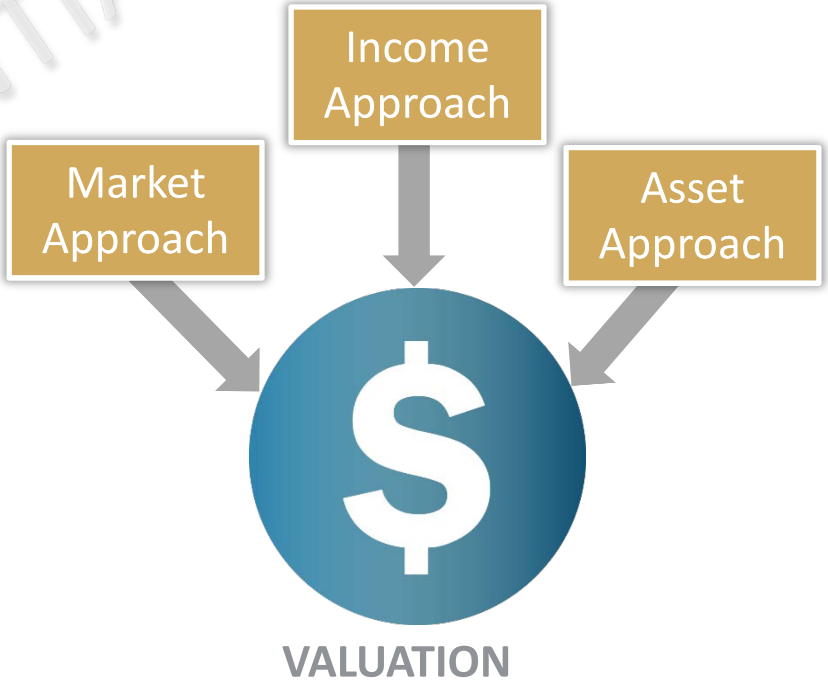
The Valuation

Negotiated Valuation

- The ESOP sale is a negotiated M&A transaction with the ESOP Trustee, who hires an independent valuation firm to determine the Fair Market Value
- The purchase price cannot exceed "Fair Market Value" as determined on an arm's length basis by a neutral valuation firm
- Transactions are subject to IRS and DOL regulation and compliance

Valuation takes into consideration:

- Historical and projected financial performance, including the ability to achieve projected financial performance.
- Other issues that could impact the future of the business (i.e., operational improvements, changes in product lines, etc.).
- Reasonableness of earnings normalization adjustments.
- Growth, profitability, and size.
- Concentration (customers, suppliers, product lines, geography, employee, etc.).
- Depth of management.
- Industry and economic trends.



ESOP Tax Saving Considerations

Post-ESOP Company Tax Savings

- A 100% S-Corp ESOP is exempt from Federal and State Income Tax. This tax savings will significantly increase the cash available to pay the selling shareholders.

Pre-Closing ESOP Contribution Deduction

- The Company can form the ESOP effective **January 1, 2020** and make a *non-cash* 2020 contribution to the ESOP. The expected 2020 ESOP contribution deduction would approximate 25% of 2020 eligible payroll. The same would go for the pro-rata portion of 2021 prior to closing the ESOP transaction.

Tax-Free Sale by Electing 1042

- IRC Section 1042 enables selling shareholders to defer or eliminate income taxes on the sale of their shares to a qualifying ESOP.

Warrants as an Estate Planning Vehicle

- Warrants may be moved to later generations with virtually no estate tax costs.

ESOP Tax Benefit: For the Company

- A 100% S-Corp ESOP is **exempt** from Federal and State Income Tax. This tax savings will increase the cash available to service the Senior Debt, pay the Seller Note and then fund growth and share repurchases by approximately 35%

1.

Tax Savings *($ in thousands)*	
Taxable Income	**$5,000**
Tax Rate	34.6%
Taxes Net of Depreciation	$1,730
20 Year Cumulative Tax Savings	***$52,366***

1. Assumes 3.5% annual Taxable Income growth for 20 years

Tax-Free Sale by Electing 1042

Internal Revenue Code of 1986, as amended (Code), section 1042, allows an owner of a closely-held C Corporation to defer, or potentially eliminate, capital gains taxation on "qualified securities" he or she sells to an ESOP if the taxpayer reinvests the sale proceeds into Qualified Replacement Property ("QRP").

ESOP Transaction

Shareholders sell all of the shares creating a taxable gain

Pay Taxes

Taxable Sale

25-35% tax rate

Don't Pay Taxes

1042 Sale

Defer cap. gains indefinitely

If the Qualified Replacement Property is held until death of the selling shareholder, the property transfers to heirs with a stepped-up cost basis, *eliminating the capital gain tax*.

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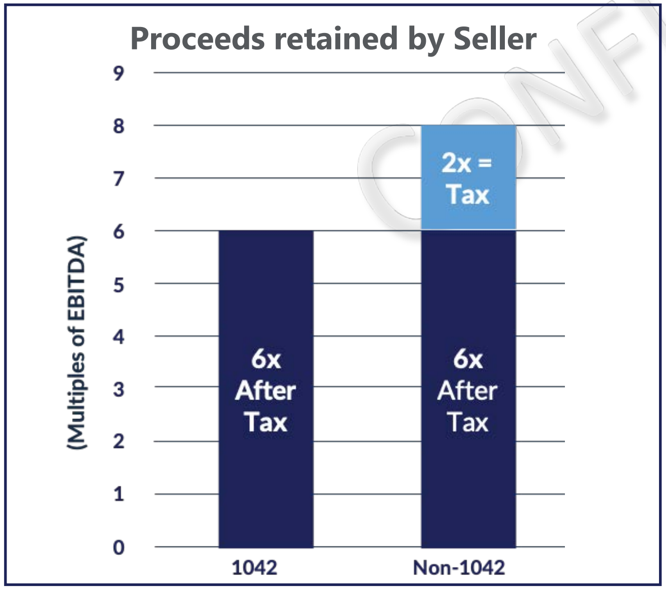
Shareholder Tax Benefit

IRC Section 1042 enables selling shareholder to **defer or eliminate capital gains tax** on the sale of his/her shares to a qualifying ESOP.

Calculation of Net Shareholder Proceeds	Third Party Sale
Calculation of Taxable Gain	
Taxable Gain	100.0%
Calculation of Taxes on Gains	
- 20.0% Federal Capital Gains Tax	(20.0)%
- 5.0% State & Local Capital Gains Tax	(5.0)%
Total Federal, State, and Local Tax	(25.0)%
Calculation of Net Shareholder Proceeds	
Sale Price	100.0%
- Federal, State, and Local Tax	(25.0)%
Net Shareholder Proceeds	**75.0%**

Calculation of Net Shareholder Proceeds	ESOP with 1042
Calculation of Taxable Gain	
Taxable Gain	100.0%
Calculation of Taxes on Gains	
- 0.0% Federal Capital Gains Tax	(0.0)%
- 0.0% State & Local Capital Gains Tax	(0.0)%
Total Federal, State, and Local Tax	(0.0)%
Calculation of Net Shareholder Proceeds	
Sale Price	100.0%
- Federal, State, and Local Tax	(0.0)%
Net Shareholder Proceeds	**100.0%**



In a taxable transaction, the Company would have to sell for approximately **33% more in order to provide the selling shareholder the same net after-tax.**

Therefore, all else equal, a 6.0x EBITDA purchase price from an ESOP will provide the Selling Shareholder with an after-tax purchase price equivalent of 8.0x EBITDA from a third-party sale.

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What is Qualified Replacement Property ("QRP")

Eligible QRP Is:

- ✓ Stocks
- ✓ Convertible Bonds
- ✓ Corporate Fixed Rate Bonds
- ✓ Corporate Floating Rate Notes ("FRNs")
- ✓ Real Estate

Eligible QRP Is Not:

- X Bank CDs
- X U.S. Government Bonds
- X Municipal Bonds
- X Foreign Securities
- X Exchange Traded Funds ("ETFs")
- X Mutual Funds
- X REITs
- X Master Limited Partnerships

Example: At Close - Sources and Uses

This is a very basic example of the Sources & Uses of a typical ESOP transaction and assumes:

- **$5mm EBITDA at a 6x Valuation Multiple; $30mm implied Enterprise Value with a $28.5mm Equity Value**
- **Lazear raises market-based Senior Debt at 2x EBITDA ($10mm) to provide cash at closing**

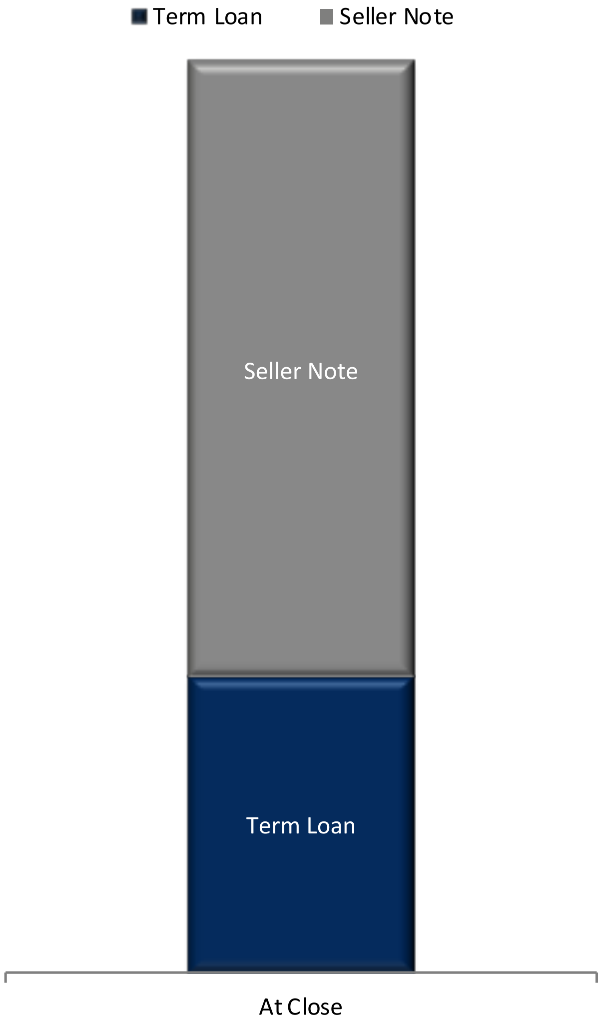
Sources & Uses
($ in thousands)

Sources		Uses	
Excess Cash	500	Existing Debt	2,000
Line of Credit Draw	-	Closing Costs	1,000
Term Loan	10,000	Cash to Sellers	7,500
Seller Note	21,000	Seller Note	21,000
Total:	**31,500**	**Total:**	**31,500**

Cash to Sellers	7,500
Seller Note	21,000
Transaction Value	28,500

- At close, the Company uses excess cash and a new bank term loan to repay existing debt (if any outstanding at close), pay the closing costs, and make an at-close cash payment to the Sellers for a portion of the purchase price.
- The financing structure will include a line of credit to be used for future working capital growth.
- The difference between the purchase price and the at-close cash payment to the Sellers is financed through subordinated seller notes.
- The amount of bank debt available at close is market-driven based on lender willingness to lend into this type of business and industry.
- **Closing Costs are paid by the Buyer (ESOP) rather than the Sellers and are added to the Seller Note – earning 12%.**

Example of Typical Debt Structure at Close



Seller Notes

- Interest rates of 12% +/- are common
- Current pay and accrued interest mix; typically 4% current pay and 8% accrued OR 4% current pay and Interest Replacement Warrants (“IR Warrants”) equal in value to an 8% IRR
- Principal repaid over time through cash flow and subsequent refinances
- Subordinated structure provides substantial flexibility to the Company

Term Loan

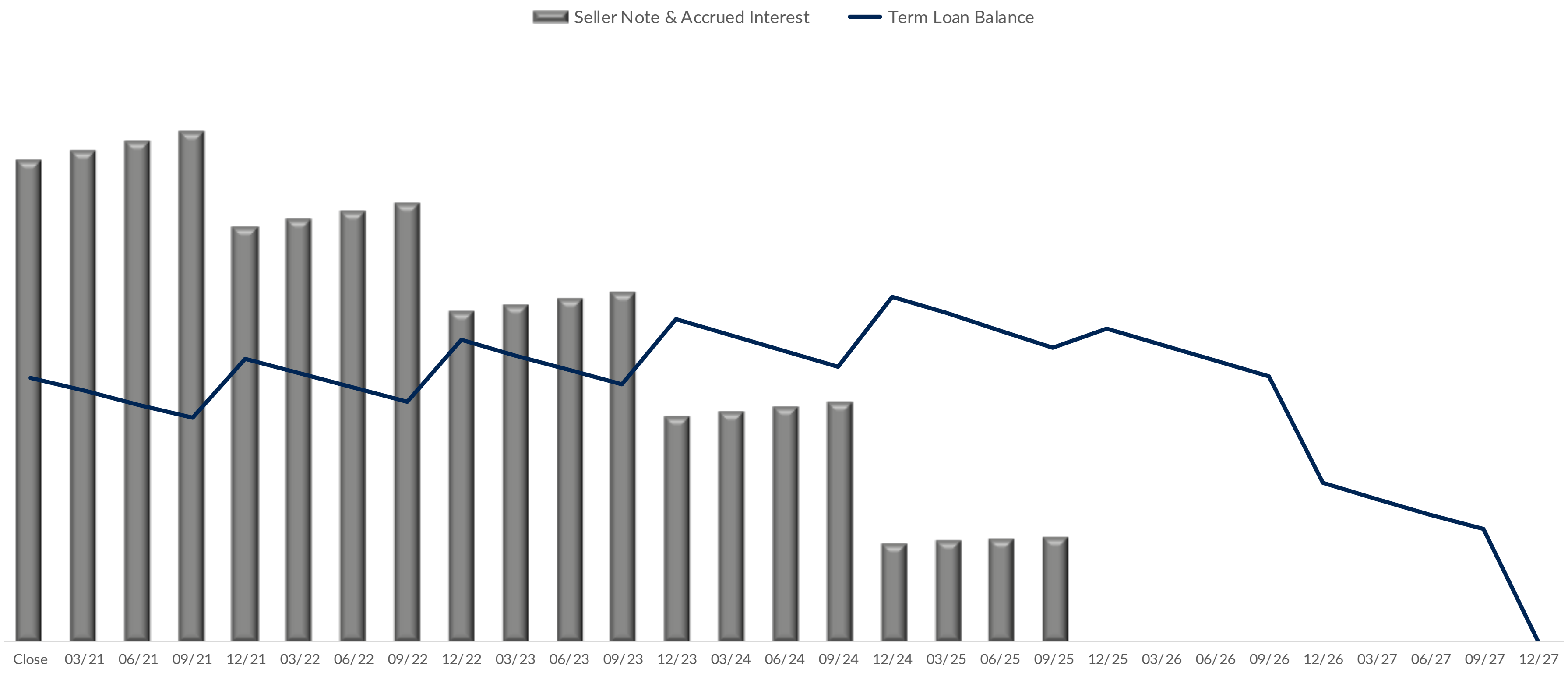
- Amount is determined by the bank and influenced multiple factors, including, but not limited to: (multiple of EBITDA, debt service coverage, collateral coverage, etc.)
- Pricing typically ranges from LIBOR + 250 to 350bps
- Five-year amortization and term is customary
- A 50%-75% excess cash flow recapture requirement is typical
- Typically no personal guarantees on bank debt

Line of Credit

- Structure typically includes a Line of Credit with availability at close, to be issued for working capital financing
- Governed by borrowing base certificate
- Typically no personal guarantees on bank debt

Example Debt Repayment – Bank & Seller Notes

Example of a quarterly debt repayment schedule:



- In order to minimize the higher interest of the Seller Notes, the Company can periodically refinance with less expensive bank debt.
- The bank Term Loan will typically require a 50%-75% excess cash flow recapture, in which the Company sweeps 50%-75% of its excess cash flow at year-end as a prepayment on the bank Term Loan. This analysis assumes that each year, the Company uses 100% of its excess cash flow to pay down the bank Term Loan.

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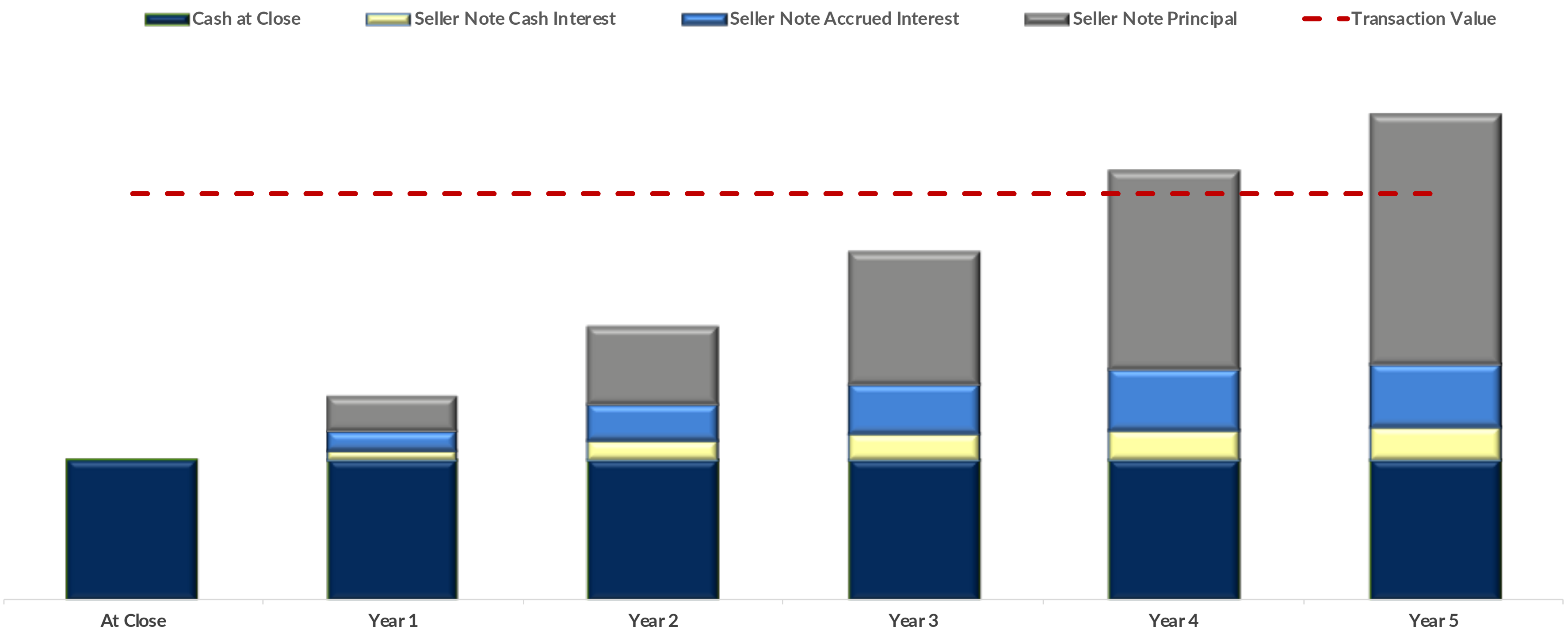
Example of Cumulative Cash to Shareholders

Interest Only Illustration – Example of Annual Cumulative Cash to Selling Shareholders

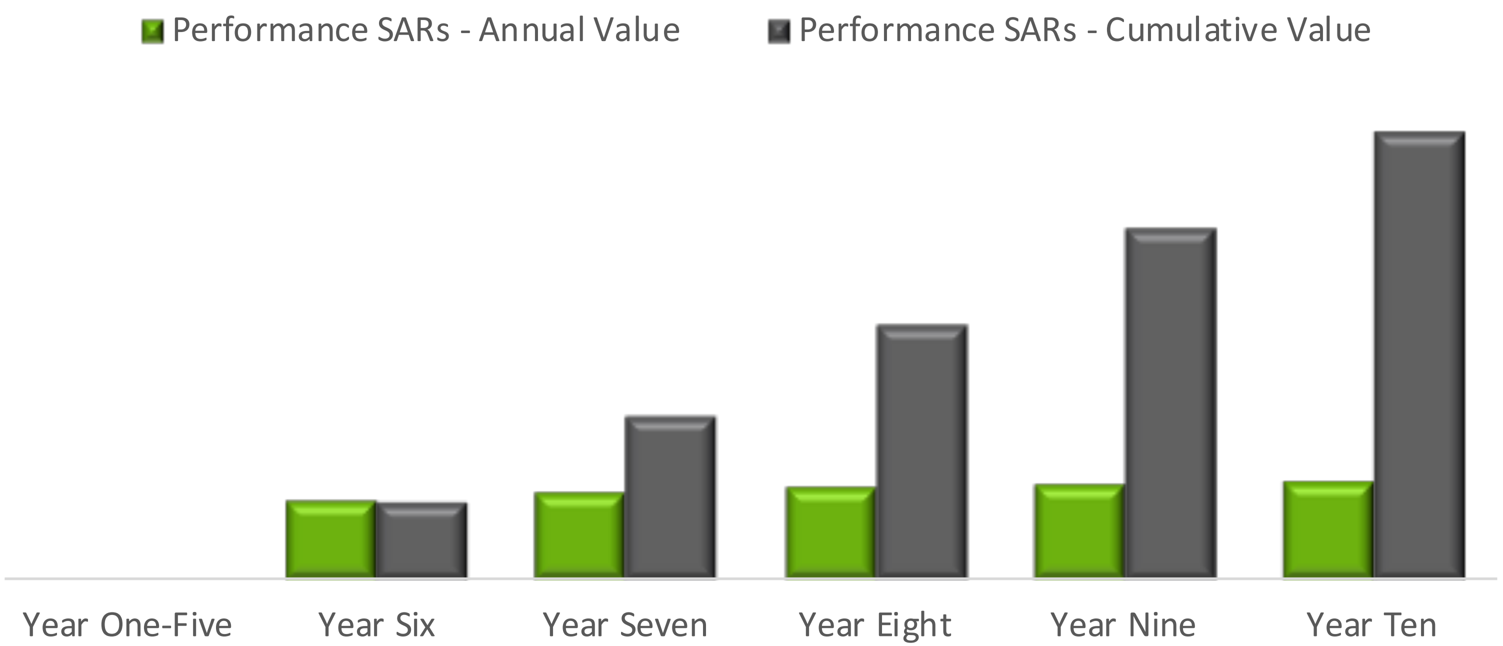


- In this example, the Seller Note is repaid over a five-year period with annual bank Term Loan refinances. Actual refinancing schedules may differ based on lending or borrowing needs.

Senior Management Incentives

ESOP structures can include features designed to incentive key management personnel. **Stock Appreciation Rights ("SARs"):** Up to 5-15% Performance SARs can be awarded when the Company exceeds projections

- A SAR is a right to receive a bonus equal to the appreciation in the Company's stock over a period of time. Calculation of SAR value mimics a stock option
- SARs provide tremendous flexibility (recipients, vesting, settlement schedule, etc.)
- SARs terms are negotiated with the Trustee and Valuation Firm



Analysis was prepared for discussion purposes only and reflects certain simplified assumptions, including but not limited to, EBITDA growth, debt repayment, working capital growth as well as other assumptions related to the valuation methodology.

Distilling it down – ESOPs in a nutshell

The Company essentially finances its own sale

- Utilizes tax breaks/incentives to make it work

Players in the ESOP: The Buyer and their team

- ESOP Trust – The "buyer"; owns the shares for the benefit of the employees
- ESOP Trustee – selected by the seller and serves as an independent fiduciary of the ESOP Trust
- Valuation Firm – an independent, third party firm that provides a fairness opinion to the Trustee on the sale

The Seller receives a portion of the value in cash at closing and carries a Seller Note for the balance

- Cash at closing to the seller is generally +/- 30% of the value
- The cash is provided by a Senior Bank facility, on market-based terms and conditions

Seller Note

- Junior note, Subordinated to the Senior Bank
- Attractively priced – typically +/- 12%
- Normally paid off in a 4 – 6-year period via periodic refinances of the senior debt

Corporate Governance

- Seller maintains operational control of the Company – nothing changes

Employees

- DO NOT pay a dime for their shares
- Shares are allocated to eligible employees each year - typically based upon W-2 wages
- Held in a tax-free retirement account with balances paid out at retirement

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Selling Shareholders

Key Employees

Company Counsel

Accounting Firm

3rd Party Administrator

Wealth Advisor

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- **Advocate for Value**
- Structure transaction to optimize results
- Present an assortment of options
- Negotiate the deal terms with the Valuation Firm and ESOP Trustee
- Keep transaction within budget
- Arrange financing and negotiate terms
- Manage deal process and professionals
- Close transaction on time

ESOP Trustee

Valuation Firm

Trustee Counsel

Potential Lenders

Lender's Counsel

The Deal Process Timeline

Preparation

- Draft Confidential Information Memorandum (CIM) and prepare financial data
- Hire Company ESOP counsel
- Begin plan design and corporate structuring discussions

Weeks 1-7

Formation Process

- Interview and select Trustee
- Identify potential lenders
- Distribute CIM to Trustee and lenders
- Valuation firm due diligence
- Lender diligence and negotiations

Weeks 7-11

Closing Process

- Prepare and negotiate ESOP sale LOI
- Negotiate lender term sheet
- Finalize and document:
  - Sale agreements
  - Lending agreements
  - ESOP Plan agreements
- 3rd-Party administrator testing

Weeks 11-16

ESOP Screening Parameters - General

Typical Owner Profile – (the more matches the better)

- **55 years** old or older
- **No heir** currently ready and capable (or interested) to take over
- **Legacy -** Interested in preserving and sustaining the legacy, history & culture of the Company
- **Rewarding the employees** is important
- **Tax Averse** – Does NOT like paying excessive taxes
- **Total Cash at Close** is NOT a motivating factor (30% vs 50% vs 70%)
- **FMV is adequate**; seller is NOT a "Last Dollar" owner

Typical Company Profile

- **EBITDA of $2.5mm or more**
- **Capable Management** available post-sale
- **Future Prospects** are solid
- **18 Employees** or more to satisfy ERISA testing requirements
- **Adequate Borrowing Capacity** – required to provide cash at close to sellers and pay closing costs

Other Considerations

- **Real Estate**
  - **Owners can SELL** at FMV as part of the sale, OR
  - **Owners can RETAIN** the real estate and the ESOP will enter into a LT lease at market rates
- **Transition Timeline**
  - Owner can walk away at close, transition over a period of time, or remain indefinitely
- **Operational Control** remains with the seller/management team post closing
- **Certainty of Closing –** virtually 100% of our transactions close, at or above indicated value
- **Broken Auctions –** these companies are ideal candidates

ESOP Screening Parameters - Industries

Unique/Niche Companies

- No natural or synergistic buyers

Contractors & Construction Companies

- ESOPs pay attractive prices
- Seller Note (fixed) vs. Earn-out (contingent)
- Great buyer of last resort

White-Collar Firms with skilled employees

- The ESOP binds the assets of the firm (the people) to the Company
- Typically provides great motivation to employees
- Preserves sometimes strong, unique/creative cultures
    - **Engineering Firms**
    - **Architectural / Design Firms**
    - **Consulting Firms (IT, HR, etc.)**
    - **Software as a Service**

Traditional Manufacturing and Distribution Companies

- High likelihood of plant closure in a strategic sale
- Owners want to maintain jobs in the community – particularly in **Small Towns**
- Preserving an owner's or family's Legacy and Reputation is important

"Corporate Divorces"

- Bickering Family Owners: Can't agree, disputes, accusations, and lawsuits
- Active vs. Inactive family shareholders
- Replace one shareholder or group with a fantastic partner: The Employees – a "win-win-win"

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