The Issue

A Publication of CFOs2Go Partners

Volume 2, Issue 8 Sep 2012

Q: Why ESOP's?

A: Liquidity without loss of control!

<u>CFOs2Go Partners</u>
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Chris Chillingworth
Jess Gutierrez
Doug Kennedy
Ed O'Dea
Chuck Swan
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Doug Kennedy
Partner, CFOs2Go Partners

We frequently hear ESOPs (Employee Stock Ownership Plans) discussed, though often not in a very favorable light. Too burdensome, too hard to manage the redemption risk, and too costly for the benefit achieved are some frequent comments we hear. It seems like business owners want a simple solution to every problem. The difficulty is that, as in any endeavor, there is a cost to achieving a certain benefit and some effort required for it as well. An ESOP can fit in certain situations. The difficulty is recognizing when!

In this brief look at ESOPs, we are going to focus on just one simple question. Why do it? Before we do that, however, we need to define what an ESOP is and summarize how it works.

What is an ESOP?

- An ESOP is a qualified employee benefit retirement plan authorized by the Internal Revenue Code designed to invest primarily in employer securities.
- An ESOP purchases company stock from existing shareholders or newly issued shares directly from the company.

How does it work?

- The company makes annual tax-deductible contributions to a Trust ("ESOT") with cash or share contributions
- Shares are allocated to employee accounts annually (usually in proportion to compensation

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- Shares allocated to employees typically vest over time
- Employees generally receive vested portion of accounts at termination, disability, death or retirement
- Private companies must give employees "put" rights to provide liquidity
- Employees may receive cash or shares, although cash is most common
- Distributed shares may be sold in the open market if company is publicly traded

ESOPs provide unique opportunities relative to other employee benefit plans

- Exempt from diversification requirement, so they can invest primarily in employer securities
- Company can use a "leveraged" ESOP to reduce financing costs, and manage repurchase obligation
- Opportunity for current shareholders to sell stock on a tax-free basis, even in an all-cash deal (C Corporations only)
- ESOPs exempt from unrelated business income tax on S Corporation earnings
- ESOPs are the only tax-qualified plan that can borrow monies to acquire securities

Business owners seeking liquidity while wishing to maintain control of the enterprise they founded are the most likely candidates for an ESOP. If a business owner is not interested in an external transaction such as taking a company public, re-capitalizing it, or selling off part ownership, then an internal transaction such forming an ESOP may offer an appealing alternative.

So what are the characteristics of a likely candidate for an ESOP? Those characteristics include:

1. Stable and growing revenues
2. Relatively large payroll base
3. Generating taxable earnings
4. Owner interested in liquidity

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So what are some industries that have successfully utilized ESOPs? These include:

1. Restaurants
2. Engineering and architectural firms
3. Healthcare staffing companies
4. General and specialty contractors
5. Call center operators
6. Grocery/supermarkets
7. Federal government contractors
8. Insurance brokers
9. Apparel and textile manufacturers
10. Transportation industry participants

Don't be discouraged if your industry does not appear in the above list. An ESOP may work for your company if the 4 requisite characteristics listed above are present.

Some basics to consider when thinking about an ESOP:

Company Size and Strength

- Size: $10M minimum revenue with $1M EBITDA as a benchmark
- Payroll Base: A large payroll base relative to the size of the transaction will allow the company to repay principal with tax deductible dollars.
- In general, you need payroll equal to 4x the required principal payment in order to achieve tax deductibility of the principal payment.
- Leveraged ESOPs require an unencumbered collateral base.
- A thinly traded (OTC-BB/Pinksheet) company considering going private

Strong Management Teams

- There must be strong successor management with a proven performance track record.
- Management team must have experience operating business in leveraged environment.

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- In all likelihood key members of management will be asked to sign an employment agreement for up to 3 years and in return receive participation in some form of stock appreciation program.

Stable and Growing Employee Base

- Generally a company with sizeable US operation versus foreign
- Generally non-union employees in plan
- Low turnover versus high turnover

Special Considerations

Some who consider ESOPs refrain from proceeding due to the lack of ease in achieving personal liquidity by selling shareholders to enable the owner or other participants to buy the trappings of success that we all seek (houses, second homes, boats, cars, expensive vacations, ability to send children to private schools) etc. There are solutions to this problem offered by a number of institutions. UBS Financial Services, Inc.'s Tammy Haygood in San Francisco has exposed us to a significant solution in which:

- Selling shareholder purchases high-quality Floating Rate Notes (FRN)
- Borrows up to 95 – 97% of the value of FRNs (does not trigger tax)
- Interest from FRNs will help offset loan expense
- Use proceeds to support actively managed portfolio and other investments/expenses
- Selling shareholder has added diversification to their investment portfolio

UBS has achieved considerable market presence with this offering.

Tammy Haygood, JD is Vice President – Investments for UBS Financial Services, Inc. in San Francisco. She holds Series 7, and 66; Life Insurance, Accident and Sickness Insurance Licenses, with a focus on helping business owners craft and implement personalized financial strategy reflective of political and social life missions. She can be reached at tammy.haygood@ubs.com, or by calling (415) 954-6725.

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Summary

If you are a business owner looking for liquidity while seeking to maintain control, an ESOP may be the right option for you. For a complete discussion of the advantages and disadvantages of ESOPs please contact Doug Kennedy at dkennedy@cfos2gopartners.com or by calling him at 415-439-9003. You may also call your CFOs2GO Partner.

Doug Kennedy, as a partner with CFOs2Go Partners, is a highly regarded and trusted advisor to high net worth individuals and family-owned businesses. His background in corporate tax and accounting issues plus his experience as a former investment advisor uniquely positions him to assist business owners in developing tax efficient financial plans to enable clients to achieve their financial objectives. Doug also consults with business owners on ownership structures, operational issues and business process redesign to achieve operational efficiency and sustainable growth.

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