PNC ESOP SOLUTIONS

ESOP INSIGHTS

UNDERSTANDING ESOPS AS AN OWNERSHIP TRANSITION ALTERNATIVE

By Julie Williams, Managing Director, National Lead of ESOP Solutions, PNC Bank

As a business owner, you have a variety of options to achieve your liquidity and ownership transition/business exit objectives, including an IPO, a sale to a third party outside buyer, or a sale to a related party such as a family member or management.

A sale to an ESOP is one transition option that is often overlooked and commonly misunderstood.

ESOPs provide owners with the ability to attain liquidity and address transition objectives in a tax advantaged manner. ESOPs provide flexibility and intangible benefits that are difficult or impossible to achieve with alternative exit strategies. Whether your goal is to diversify while staying actively involved in the business or to execute on a complete sale of the business, an ESOP can accomplish either, among other objectives.

WHAT IS AN ESOP?

In its simplest form, an ESOP is a qualified retirement plan. ESOPs differ from other qualified plans in two key ways: (1) they are permitted to borrow money and (2) they are designed to invest primarily in the stock of the sponsor company. These features make it possible for ESOPs to acquire shares of stock from selling shareholders and facilitate the transfer of ownership to employees (as beneficiaries of the ESOP trust) over time. Beyond being a traditional retirement plan, ESOPs serve as a corporate finance vehicle that can provide liquidity to selling shareholders while transforming employees into owners.

HOW DO ESOPS WORK?

In a traditional leveraged ESOP, the company borrows money from lenders (which may be third party sources or selling shareholders themselves), and then loans the proceeds to the ESOP trust for the purpose of acquiring shares. The shares purchased by the ESOP are allocated to employee accounts over time as the ESOP repays its loan to the company. The end result is that employees obtain beneficial ownership in the company.

Employees have a right to receive a distribution from the plan upon separation from the company by reason of retirement, termination, disability or death. The amount that the employee is entitled to is the value of their account which, in the case of an ESOP, would be the current value of the stock allocated to their account.

INTANGIBLE BENEFITS TO OWNERS

It is common for owners to articulate objectives that go beyond the price they hope to achieve from the sale of their business. They want to take care of their loyal customers, employees and vendors — and they want their mission and legacy to continue to thrive. In some cases, owners want to begin the transition process and obtain liquidity, and at the same time remain involved and possibly even retain operational control.

ESOPs facilitate a succession strategy that allows the owner to steadily transition from CEO to board member to full retirement as desired. Many owners value the opportunity to be a part of a successful handoff to the employees, setting the company and the employees on a course that is congruent with their goals for both parties.

STRUCTURAL BENEFITS FOR THE COMPANY

ESOPs can address a number of common concerns that sellers and buyers have around executing the sale transaction and successfully operating under a new ownership structure.

Reduced execution risk: You may hear that ESOPs are a "friendly buyer." ESOPs can allow for transition of ownership with little disruption to the business. Compared to a third party sale, there is generally a higher certainty of closing once the decision is made to consummate a sale to an ESOP.

Flexibility: The terms of the transfer of the ESOP shares can be very flexible. An owner may sell the entire stake in the business, sell a minority stake as a way to "take chips off the table" and diversify assets, or set in motion a plan to gradually sell shares to the ESOP over time.

Ability to maintain legacy and reward employees: Owners often care deeply about the culture of their company and believe that the employees and the culture itself are a key element of the company's past and continued success. Owners who prioritize preservation of culture and perpetuation of legacy are often strong candidates for an ESOP.

ESOPS HAVE A POSITIVE IMPACT ON EMPLOYEES

EMPLOYEES OF ESOP-OWNED COMPANIES:

Job Satisfaction & Motivation	**Exhibit higher job satisfaction, organizational commitment, motivation and workplace participation**
Job Security	**Are four times less likely to be laid off than employees of companies that do not have employee ownership[1]**
Superior Retirement Benefits	**Retire with substantially higher retirement assets** ▪ Companies contribute 50% to 100% more to ESOPs than non-ESOP companies do to 401(k) plans.[2] ▪ ESOPs have higher rates of return than 401(k) plans and are less volatile.[2]

1 The General Social Survey, 2014

2 Department of Labor Study, NCEO, 2017

TAX BENEFITS

The tax advantages associated with ESOPs can be significant for companies that sponsor ESOPs as well as for the selling shareholders who opt to transact with them. To encourage the application of ESOPs, Congress enacted certain tax incentives under the premise that employee ownership enhances company productivity, marketplace competitiveness and employee job security, satisfaction and motivation.

When the intangible benefits of employee ownership (employee engagement, motivation, productivity) combine with meaningful cash flow enhancements from tax savings, the impact on companies can be tremendous.

ESOPS HAVE A POSITIVE IMPACT ON COMPANIES

INDEPENDENT STUDIES SHOW COMPANIES WITH EMPLOYEE OWNERSHIP ARE:

More Competitive	**More stable and better for the larger economy** ▪ S corporation *ESOPs outperformed the S&P Total Returns Index* in terms of total return per participant by *62%* from 2002 to 2012.[1]
More Stable and Resilient	**Perform better through difficult business, economic and industry cycles** ▪ The *default rate on bank loans to ESOP companies* during the period 2009-2013 was, on average, 0.2% percent annually — *10 times lower* than levels experienced more broadly by mid-sized U.S. companies.[2]
Great Places to Work	**Are frequently recognized as great places to work and experience greater employment stability** ▪ Generally, about 55% of the organizations on *Fortune*'s "100 Best Companies to Work For" list (that are not nonprofits or professional partnerships) have some kind of employee ownership plan.[3]
Strong Contributors to the Economy	**Companies that are S corporation ESOPs are proven job-creators, even during tough times** ▪ While overall U.S. private employment in 2008 fell by 2.8%, employment in surveyed S corporation ESOP companies rose by 2%.[4]

1 Ernst and Young's Quantitative Economics and Statistics (QUEST), 2015
2 Default Rates on Leveraged ESOPs, 2009–2013 Summary, NCEO, 2014
3 NCEO — compilation of multiple *Fortune* 100 Best Companies to Work For rankings since 2006, 2017
4 Georgetown University / McDonough School of Business Study, 2010

Seller tax benefits: Under certain circumstances, sellers can defer or potentially eliminate capital gains tax on the sale of stock to an ESOP (utilizing Section 1042 of the Internal Revenue Code ["IRC Section 1042"]) and therefore may achieve higher after-tax proceeds compared to a sale to a third party.

Company tax benefits: There are several avenues through which a company can realize tax benefits associated with ESOP ownership. Most significant is the case where the ESOP owns 100% of the company's stock and the company is an S Corporation.

The ESOP trust is a tax exempt entity — once the trust owns 100% of the company's outstanding equity, the company no longer is required to make tax distributions on earnings attributable to ESOP shares.

Effectively, the 100% S Corporation ESOP-owned company no longer pays federal income tax and in most cases no longer pays state and local income tax.

This meaningful cash savings is retained in the company and can be used to repay transaction debt and to reinvest in the business.

In the case where the ESOP owns less than 100% of the stock, the company will still benefit meaningfully by having the ability to deduct the full transaction price over time.

A FAVORABLE ENVIRONMENT FOR ESOP TRANSACTIONS

Current market conditions are favorable for ESOP transactions. Through 2015 and 2016, the strength of the economy has led to strong valuations and capital markets — both of which are forces behind robust interest in selling businesses. ESOPs, as one of the few ways to sell your business, are capturing their fair share of this wave of ownership transition.

FLEXIBILITY — NOT COMPLEXITY

We often hear ESOPs described as complex. However, it is because ESOPs can be used to address myriad possibilities that makes them such a powerful tool. It is a widely held view of many ESOP companies that the benefits of employee ownership are worth overcoming the inherent complexities of selling to and operating with an ESOP.

It is important to note that ESOPs are not appropriate or attractive for every situation. There are additional considerations that should be weighed, including but not limited to:

- **Inconsistent earnings (cyclicality):** ESOPs tend to be best suited for businesses with consistent and predictable earnings so that they are well-positioned to service the transaction debt and future repurchase obligation requirements.

- **Compelling strategic offers:** ESOPs can pay no more than fair market value for the stock. Fair market value is defined as the price negotiated between a hypothetical willing buyer and willing seller. If the selling shareholder is seeking to maximize his or her sale price, then an ESOP may not be the best means to achieve this goal — particularly if there is a buyer that would be willing to pay a premium for the business (a price greater than fair market value) for strategic reasons.

- **Upfront liquidity:** When selling to an ESOP, the cash proceeds available to the selling shareholder at closing will be limited by the company's debt capacity. This means that a meaningful portion of the total sale proceeds may be deferred and paid to the seller over a period of time. If you desire to maximize cash proceeds at closing, an ESOP may be less attractive versus alternative sale options. Further, if the company's operations require significant growth capital or have other demands on capital, a leveraging event for an ESOP may not be in the best interest of the company.

Still, it is a worthwhile exercise to understand whether an ESOP could be used as a tool to realize the financial, tax, organizational, personal and legacy benefits of ESOPs.

SELECT FINANCINGS WITH ESOP CUSTOMERS

- Arranged $1 million senior revolver and $8 million senior term loan to facilitate a 30% ESOP purchase of a kitchen, bath and home goods distributor
- Arranged $40 million senior revolver and $45 million senior term loan to facilitate 100% ESOP purchase of Southeast construction contracting services company
- Arranged $130 million senior ABL revolver to recapitalize and reorganize 100% ESOP-owned Midwest technology company
- Provided $65 million senior revolver to Northeast government contractor to finance ESOP share redemptions
- Provided $30 million senior revolver and $30 million senior equipment facility for Northeast truck-leasing business to facilitate minority ESOP purchase and scheduled equipment acquisitions
- Financed $130 million in senior credit facilities to manufacturer of commercial kitchen equipment
- Financed $49 million in senior credit facilities to automotive original equipment manufacturers
- Provided $34.5 million bank loan to facilitate investment in Qualified Replacement Property for ESOP Section 1042 transaction
- Financed $28 million sale to ESOP of manufacturer of clean room facilities
- Financed $25 million sale to ESOP-owned manufacturer of retail selling environments
- Refinanced $6 million in senior credit facilities to ESOP-owned distributor of educational materials for health and science professionals

ABOUT JULIE WILLIAMS

Julie Williams is Managing Director and the National Lead of ESOP Solutions for PNC Bank. She has more than 15 years of experience advising companies and business owners on various aspects of ESOP transactions. Clients and prospects of PNC Bank leverage her knowledge and experience as they evaluate the benefits and considerations of using an ESOP as an ownership transition and liquidity solution. Williams also serves as a resource for PNC clients as they execute their corporate strategy with the added complexity of ESOP ownership.

Prior to joining PNC, Williams held senior positions with major financial institutions in the Midwest, focusing on ESOPs.

Williams earned a bachelor's degree in business administration from the University of Michigan and a master's degree in business administration from the University of Chicago, Booth School of Business. She is licensed by FINRA with a Series 79 and Series 63.

FOR MORE INFORMATION

Ask how PNC's ESOP Solutions group helps companies transition to an ESOP structure and assists existing ESOP clients in maximizing performance. Contact Julie Williams at **julie.williams@pnc.com** or **616-771-8864**.

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