PNC ESOP SOLUTIONS

ESOP INSIGHTS

HOW PRIVATE BUSINESS OWNERS CAN ACHIEVE DIVERSIFICATION THROUGH A MINORITY ESOP

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

Many private business owners invest significant personal assets and reinvest the majority of the company's earnings in the business to grow the company and create equity value. Consequently, you likely have become overly concentrated in one asset class: your business, with all or most of your net worth entwined in the company. While reducing the risk profile of your business through diversification of customers/products/vendors has likely been a top priority, you may not always view your wealth concentration in the company as risky. This financial reality reflects the position many privately-held business owners face today.

As the business matures and you approach retirement, conventional investment guidance suggests there comes a time when it is prudent to shift into wealth-preservation mode.

Diversification is a hallmark of just about any prudent investment strategy. Most investors understand that "putting all of your eggs in one basket" can lead to a higher risk of loss.

To mitigate risk and preserve wealth, especially in today's volatile marketplace, best practices suggest investing in a broad range of asset classes. According to the Financial Industry Regulatory Authority (FINRA), "The general consensus among financial experts is that an adequately diversified portfolio should have no more than *10 to 20 percent* of total investment assets in company stock."

Eventually, harvesting some portion of the wealth you have created through your business is appropriate and vital to ensure your personal financial security for the long term.

WEALTH PRESERVATION WITH AN ESOP

Many owners struggle with the appropriate time to transition from a "wealth creation" strategy to a "wealth preservation" focus. Almost all business transition options require the sale of a majority or all of the company. However, there are a few attractive options that could allow you to continue to manage your business while also taking chips off the table.

Employee Stock Ownership Plans ("ESOPs") may be able to address both your liquidity needs and your desire to maintain control of the business while retaining the economic benefits of continued ownership. By using an ESOP, you will also be transitioning some portion of ownership to your employees over time.

Here are some of the key benefits of selling a minority stake to an ESOP:

- **Control** ESOPs are flexible — you can sell any portion of your business to an ESOP at fair market value. Selling less than 50% allows you to retain full control of the business. While active in the business, you continue to benefit from growth in the value of your retained ownership. However, if the company declines in value, you have reduced your downside risk by locking in the value of the shares sold to the ESOP.
- **Continued Involvement** Typically, day-to-day operations and management of the company do not change after selling to an ESOP. Owners who want liquidity but are not ready to relinquish control and oversight can gradually begin the process of converting their closely held ownership to a liquid diversified portfolio in a measured approach and ultimately determine the time of their exit.

- **Tax Benefits** Because there are significant tax benefits and incentives associated with 100% ESOP ownership, many owners in the last decade have opted to transition 100% of the ownership to employees in an outright sale. However, selling less than 50% to an ESOP can also deliver powerful benefits. The tax benefits created when selling a minority stake to an ESOP are significantly more compelling than another common liquidity event for shareholders — a leveraged dividend. With a leveraged dividend, only the interest on transaction debt is tax deductible, whereas with an ESOP, the full purchase price (both principal and interest on transaction debt) is deductible over time. These tax incentives result in enhancements to cash flow that can initially be used to repay transaction debt and longer term can be used to fund growth.

- **The Future** A partial or complete sale of the company to an ESOP does not preclude a sale to a third-party buyer down the road. In a future sale, you would receive liquidity for the remainder of your shares, and employee owners would also benefit from that sale, particularly if sold at a premium. Alternatively, many owners who initially sell a small percent to an ESOP will eventually sell the remainder to the ESOP in subsequent transactions, so that the company is eventually 100% ESOP owned.

Two Important Considerations

While the benefits are substantial, there are several considerations to take into account as you consider selling a minority stake to an ESOP.

- **Leverage** The ESOP uses funds that the company borrows to buy out the selling shareholder. Selling a smaller percentage to an ESOP has the benefit of keeping a lower corporate leverage profile, thereby conserving cash flow and future debt capacity to grow the company. However, if the company already has debt, there may not be an opportunity to obtain immediate liquidity from an ESOP. If it is important for the company to have access to capital to grow, if the business is capital intensive or has inconsistent cash flows, an ESOP may not be an appropriate path.

- **Culture** An ESOP is a qualified retirement plan and will ultimately deliver beneficial ownership broadly to employees. ESOPs are an ideal fit where there is already a culture that is employee-centric. ESOPs are often implemented in companies where culture, legacy and values are prioritized. They are often a fit for owners who fear loss of these important attributes if the company were sold to a third party.

A Balanced Approach

Diversification for the private business owner can be complicated when there are multiple competing priorities. Under the right circumstances and guidance from qualified tax professionals and financial advisors, an ESOP can be a versatile tool that uniquely addresses multiple ownership and corporate objectives.

Ultimately, timely analysis and decisions regarding your wealth and estate planning will benefit not only yourself but also the company. While the options for business owners to diversify are few in number, it is important to understand how your business fits within the context of your total asset portfolio and when it might be appropriate to consider reducing risk to preserve your wealth.

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**.

PNC ESOP SOLUTIONS