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ESOP INSIGHTS

HOW TO OPTIMIZE YOUR BUSINESS SUCCESSION PLANNING WITH AN ESOP

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Business succession planning is a dynamic process that can address a full spectrum of issues from your personal financial needs to your company's long-term viability. It is about discovery, analysis and revealing the best strategy for you to achieve your unique financial and personal objectives. The process is likely to be far more wide-ranging and rigorous than you might think. In this article, we explore key tenets of business succession planning and more specifically how these concepts intersect with ESOPs.

As a business owner, you have a variety of options to achieve your liquidity and exit objectives, including an IPO, a sale to a third party, or a sale to a related party such as a family member or management. Alternatively, selling your business to an Employee Stock Ownership Plan (ESOP) is a transition option that can provide you with the ability to attain liquidity and address ownership transition objectives in a tax advantaged manner. ESOP strategies can also bring several advantages that are not available with other transition strategies[1]. See "**Understanding ESOPs as an Ownership Transition Tool**" for a more comprehensive overview of the benefits and considerations of selling your business to an ESOP.

TYPICAL GOALS OF A BUSINESS TRANSFER

Most business owners contemplating selling or transferring their businesses have two goals in mind: (1) obtaining full value to fund their retirement and (2) transferring that value to family or other beneficiaries in the most tax efficient manner.

While most owners understand that a transition strategy is critical both personally and for the ongoing success of the company, in reality, it is estimated that 75% of owners, even those closely approaching retirement, either have no plan at all or have a transition strategy that is not fully developed[2]. Deferring important business succession planning can lead to many negative consequences, including an inability to sell or exit when the time is right, failure to achieve your desired sale price and unexpected tax obligations.

A strong planning framework will assess the health of your business, provide adequate planning time and equip you with the right information to develop a favorable transition or exit plan. All options should be considered in concert with your identified priorities. A weak process could yield less than desirable results. The following three drivers are critical components of any business succession evaluation:

1. Competitive Positioning: Articulate the company's value proposition after the transaction.

2. Capital Market Conditions: Frame valuation objectives based upon current market conditions.

3. Shareholder Dynamics and Objectives: Achieve the selling shareholder and stakeholders' goals.

COMPETITIVE POSITIONING

As a business owner, you likely recognize that shareholder value is a function of the company's ability to successfully compete in the marketplace; companies with a competitive and sustainable advantage will realize shareholder value that reflects their superior position in the industry. There are many metrics to assess your overall business health, including but not limited to:

- Sales patterns
- Growth opportunities

- Management and leadership
- Profitability trends

Ultimately, your ability to achieve the best valuation for your business will rest on your ability to clearly illustrate the value proposition.

Perhaps the most important measure of value is the quality of your management and staff. In fact, all buyers, including ESOPs, will consider the strength of management in their assessment of value. A weak management team or lack of succession could lead to lower valuations (or limit the universe of potential buyers).

For example, to successfully transition your business to an ESOP, you must have a strong leadership team in place since the buyer (the ESOP) will not bring new management talent to the table. However, a strategic buyer might prioritize strength of leadership differently depending on how its own talent profile will fit with your business. And a financial buyer may also bring additional talent resources to improve the competitive positioning of the company. Regardless, understanding your organizational health can give you the opportunity to address weaknesses in advance to maximize your potential value when the time to exit materializes.

Superior strategic positioning can also be either achieved or constrained depending on external factors affecting the marketplace, including access to growth capital and to key talent. Current financial markets are borrower-friendly with competitive pricing and banks jockeying to deploy capital. Conversely, the labor market is tight. As key members of leadership and rank-and-file employees retire or turn over, many companies face significant challenges attracting the next generation of talent.

According to the *Hays U.S. 2018 Salary Guide*, three-quarters of the 3,000 U.S. employers and managers indicate that their industries face severe skills shortages[3]. This shortage is so pronounced that more than 90% of employers say the problem is negatively affecting productivity, employee satisfaction, and turnover. Accordingly, the looming talent shortage may have a detrimental impact on shareholder value if not addressed.

Interestingly, ESOPs can address the talent dearth in other ways. *The Hays Guide* cites that the most common recruiting method to attract new talent is to promote company culture (offering competitive salaries is the next most common). ESOPs are a well-known strategy for contributing to a strong employee-centric culture. ESOPs can enhance recruiting efforts, improve job satisfaction of employees (thereby reducing turnover) and lead to higher productivity. All of these factors potentially enhance a company's competitive positioning and shareholder value[4]. See "**Attract. Retain. Motivate and Build Value: The Effect of ESOPs on the Workforce**" for more information on this topic.

Beyond the employee-related benefits, ESOPs may further enhance competitive positioning through significant tax benefits. Most notably is the tax exempt status of 100% S Corporation ESOPs.

Essentially, the company is 100% owned by a tax exempt trust and therefore is no longer required to make tax distributions to service shareholder federal income tax obligations as well as in many cases state and local income taxes.

With tax rates for taxable entities ranging between 21% (C corporations) and 37% (shareholder tax rate for S corporations), a 100% S corporation ESOP may have as much as 37% more net cash flow than their taxable competitors which can be used to reinvest in strategic initiatives once transaction debt is extinguished. With the right fact pattern, corporate culture and shareholder objectives of the current owner, the 100% S corporation ESOP could be a viable alternative.

CAPITAL MARKET CONDITIONS

Value is a top consideration for most business owners when they transition their business. Owners must consider the value that can be achieved from a sale to an ESOP relative to financial and strategic buyer value (all on an after tax basis), as well as differences in deal terms for each buyer type.

While price may be a top consideration, equally important factors may include the timing of receipt of cash proceeds, tax implications from the sale, and what your ongoing cash flows will look like after the sale compared to before the sale. Consideration should also be given to your full financial profile post sale, including:

- Your personal financial statement
- Liquidity and cash-flow needs
- Risk tolerance
- Asset protection for you and your family

Understanding your goals for current and future liquidity and whether or not each exit alternative accomplishes them will be critical to identifying the right solution.

Several factors will influence the amount of cash you can generate both at the time of a sale and on an ongoing annual basis beyond the transaction. Such factors include taxes, reinvestment rates of return, risk tolerance and choice of buyer. When selling to an ESOP, an owner may be able to defer capital gains tax from the sale, potentially into perpetuity. However, when selling 100%, some of the purchase price may be deferred due to limitations on how much the business can borrow to facilitate the transaction. Until the owner receives all proceeds from the sale, they will remain at risk relative to the performance of the business.

Alternatively, selling to a strategic or financial buyer might yield greater up-front liquidity. However, you should also consider the impact of taxes on your proceeds and reinvestment rates of return in the current capital markets because you may find that your annual cash flow will drop materially relative to the cash flow you were accustomed to prior to the sale. You need to balance the risk factors and family harmony implications of an all-liquid, well-diversified portfolio versus an illiquid private business.

SHAREHOLDER DYNAMICS AND OBJECTIVES

After financial peace of mind, value-based goals can be key objectives of many business owners. Integration of financial goals with values-based goals can develop into a succession plan that considers the impact on all key stakeholders, including employees, family, and community. Developing a strong succession plan and communication strategy enhances both the owner's likelihood of successfully achieving his/her objectives and the company's ongoing success post transition.

Values-based objectives and shareholder dynamics - when combined with competitive position and capital markets condition - often shape the ultimate transition strategy. For example, an ESOP may be the most employee-friendly alternative but may not be a viable option based on the company's financial profile.

A sale to a strategic buyer may be the only option that addresses the upfront liquidity needs of all stakeholders, but values-based objectives might narrow the universe of potential buyers. To the extent a business owner has no family to leave their wealth to or no desire to do so, employees and charities can be a primary beneficiary rather than the IRS.

In cases where maintaining family ownership is a top priority, a strategy to transition the business tax efficiently and ensure that the owners' liquidity needs are met will be the primary drivers of the solution. Whether you keep the business with the family or sell to an ESOP, the owner's legacy can be perpetuated via their communities and employees rather than leaving money to the IRS.

SUMMARY

Business succession planning is truly a dynamic process. There are four potential beneficiaries from your lifetime financial achievement: the IRS, your family, community and employees. A comprehensive planning process will include deep discovery of all stakeholders' goals and objectives, analysis of all alternatives for transitioning your business, and measurement of each alternative with respect to your goals. It should demystify the impact of each exit strategy on your financial profile over the near and long term, and it should reveal opportunities to improve your long term financial security irrespective of which alternative you pursue.

ADDITIONAL CONSIDERATIONS

While ESOPs can have significant benefits for owners, management and employees, they are not the best strategy in every situation. As you consider an ESOP, ask yourself the following questions:

- Does your company have consistent earnings? 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.
- Are you anticipating compelling strategic offers? ESOPs can pay no more than fair market value for the stock. 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.
- Do you require upfront liquidity? When selling to an ESOP, a meaningful portion of the total sale proceeds may be deferred and paid to the seller over a period of time.

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**.

1 "Understanding ESOPs as an Ownership Transition Tool," PNC, 2017.
Available at: https://www.pnc.com/content/dam/pnc-ideas/articles/CIB_UNDERSTANDING-ESOPS.pdf

2 "Thinking about selling your business? Consider this your roadmap," Harris Williams, 2015.
Available at: https://www.harriswilliams.com/system/files/case_study/hw_how_to_sell_updated_august_2015.pdf

3 "Hays U.S. 2018 Salary Guide," Hays, 2018. Available at: http://www.hays.com/resources/2018-salary-guide/index.htm

4 "Attract. Retain. Motivate and Build Value: The Effect Of ESOPs On The Workforce," PNC, 2017.
Available at: https://www.pnc.com/content/dam/pnc-ideas/articles/ATTRACT-RETAIN-MOTIVATE-BUILD-VALUE.pdf

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