ESOP Planning: Expand & Grow Your ESOP

Companies with Employee Stock Ownership Plans (ESOPs) will face challenges that impact their strategic direction. These challenges may include balancing competing claims on capital, determining if the ESOP ownership position should change and deciding if the company should undertake strategic acquisitions. These are but a few examples of potential challenges faced by ESOP companies, and business leaders need to know the available tools to expand and grow shareholder wealth.

Balancing Competing Claims on Capital

The first step to determining the optimal direction for an ESOP company is through strategic analysis. Business leaders need to evaluate the Company's long term goals, predicted financial conditions, risks and value trajectories. Inevitably, there will be competing claims on capital. Therefore, business leaders will need to allocate resources based on the needs of the business such as capital expenditures, employee benefit plans, debt service requirements, research and development costs among others.

ESOP companies should prepare integrated financial modeling while assuming an ideal capital and ownership configuration to answer the question, "What do we want to be?" Companies should also develop approaches that explore avenues to reduce and remove potential impediments to achieving their goals.

The Question of ESOP Expansion

For existing partial ESOP companies, an important consideration in strategy should be determining the optimal expansion of the ESOP. There can be a number of obstacles when considering expansion. Three common hurdles include: (1) the reluctance of non-ESOP shareholders to sell, (2) an "ESOP-only" ownership mix might not be desired for the owners or management and (3) transaction financing may be scarce and time-consuming. Fortunately, there are several possible solutions for each of these challenges, some of which are summarized below.

The first two challenges concern the ownership mix. Non-ESOP shareholders and/or management may occasionally be hesitant to expanding ESOP ownership. A possible solution to this problem is by implementing an equity incentive plan. ESOP companies are frequently adopting incentive plans that provide synthetic equity to the management team and the Board of Directors. These plans accomplish two goals: (1) the upside is theoretically unlimited, thereby motivating equity awardees and (2) the upside is tied to shareholder value, thus aligning interest.

The second obstacle concerns transaction financing. If the business owner's objective is the total sale of his or her shares in the company, there are key questions that impact the outcome that must be addressed. For example, if there might be a borrowing base shortfall, who will fund the gap? The answer may be any combination of the management team, employee 401(k) rollover balances, mezzanine funds or seller paper. Seller paper typically includes a warrant component to provide a market-based return commensurate with risk. Financing with seller paper affords the business owner potential upside and under certain circumstances, tax savings. It is important to remember that each funding source has its own advantages and disadvantages. The choice of funding will directly affect cash flows and share price trajectory. Best practice is to conduct a thorough analysis of the funding mechanisms and their pros and cons.

Strategic Acquisition

Along with evaluating the financing issues for ESOP expansion, the option to make strategic acquisitions is an important consideration. An acquisition should meet a strategic need, such as the need to expand geographically, to make a vertical acquisition or even make a horizontal acquisition of a key competitor. It is advisable that the ESOP trustee be involved with the strategic acquisition discussion. In certain circumstances, voting by the ESOP participants is required to complete the transaction.

The Right Guidance to Grow Your ESOP

ESOPs present a unique combination of fields such as valuation, business transaction dynamics, tax law and regulatory compliance. Knowledge in all of these areas is required to effectively and efficiently grow and expand an ESOP. Business leaders should work closely with qualified advisors in order to enhance shareholder wealth.

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