

SECOND STAGE ESOP FINANCING

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Many private companies elect to pursue a phased strategy when selling the business to a leveraged ESOP. There can be a number of reasons for choosing this strategy. Phased transactions can be mandated by lenders or elected by private company owners. In most cases, cash flow limitations, collateral restrictions, working capital/capital expenditure requirements, or simply the wishes of selling shareholders dictate the use of this strategy.

The initial transaction, in many cases, is often structured as a sale of minority block of stock. The second stage transaction then causes a change in control and another recapitalization of the company. It is assumed that a company that has successfully completed, or is in the process of repaying debt from a minority interest transaction, has become fairly proficient in debt management. A second stage transaction, which typically exceeds the loan amount of the first transaction, requires a company to retain that proficiency as part of its ongoing culture.

Before a lender can decide whether or not a second transaction is creditworthy, a transaction structure must be presented that addresses the four C's of lending: Character, Cash Flow, Collateral and Capital.

THE FOUR C'S OF LENDING

Character

The selling shareholders, perhaps even the founding shareholders, are pursuing a second stage transaction as a continuation of an exit strategy already put in motion. The lender has carefully observed the management team during the loan period of the initial transaction. This group of key managers should have established the nucleus of an employee ownership culture and successfully demonstrated its management capabilities. If the managers have failed in this endeavor, lenders become concerned since selling shareholders may not be involved in the business once their shares have been sold to the ESOP. Lenders will insist on depth in management.

Some lenders have required that prior to the completion of a second stage transaction, contractual arrangements are made with key managers. These employment contracts can include base compensation, bonuses, non-compete agreements and in some instances, additional forms of equity ownership. This request by lenders provides them with the continuity of management with rewards tied to pay for performance. These performance criteria can be tied to the performance of the company, or the repayment of the debt, or both.

Cash Flow

This second stage financing is under consideration because the company has had a successful track record of retiring the non-productive debt associated with the first transaction. As the structuring of the first transaction was important with respect to satisfying its ongoing working capital and capital expenditure requirements, the structuring of the second stage transaction is even more critical. Why? The selling shareholders are attempting to sell their remaining shares as much as they possibly can, while the managers and employees feel that they can now affect a transaction, which eventually puts them in control. It sounds as if both buyer and seller are trying to achieve the same eventual goal; however, the lender cannot allow emotions to dictate the transaction.



Cash flow will dictate the viability of the transaction. Lenders will require realistic projections substantiated by a marketing/business plan that will allow the company to meet its projections. Asset-based lenders that fund leveraged buyout transactions (make no mistake, ESOPs are leveraged buyouts) are most concerned with the first three years after funding. It has been their experience that leveraged transactions that go bad do so in the first three years. The debt service coverage that most lenders look for would be in the range of 1.25 to 1.75 times cash flow. This should also take into account debt needs for working capital and capital expenditure requirements.

There may be occasions where the collateral may not be sufficient and the lender bases a significant amount of its credit approval on cash flow. Their loan documentation might require that the lender institute a cash flow sweep of excess cash flow to pay down debt as quickly as possible. The amount of percentage of the sweep should be thoughtfully negotiated as it must consider working capital/capital expenditure requirements and its interrelationship to Section 415 and limitations of tax deductibility. Finally, the deal structure and its related cash flow should address the company's surplus debt capacity and access to additional credit. Availability of credit to fund the company's growth is very important to the success of the second stage deal.

Collateral

The lender that indicates that it is purely a cash flow lender is misleading its clients. All lenders seek, and in some way, obtain a second way out of a transaction. Their credit committee demands it. Lenders will collateralize your working capital needs with accounts receivable and inventories. This is logical because it ties your productive assets to productive debt. Non-productive long-term debt such as ESOP debt must be collateralized with whatever assets are remaining, including unencumbered equipment and real estate as well as liquid collateral and personal guarantees.

The last two ideas of utilizing liquid collateral and/or personal guarantees are not always palatable to selling shareholders. In some businesses, notably companies that are service oriented, the deal will demand it. This should not surprise the selling shareholders as they might have had to offer similar support to the first transaction. The selling shareholders in the second stage transaction are typically concerned about their ability to extricate themselves from the business sooner rather than later.

Liquid collateral for the transaction can be obtained through the pledging of Section 1042 replacement securities. (Section 1042 of the Internal Revenue Code [the "Code"] allows the owner of a private firm to defer taxation of gains on stock he or she sells to an ESOP if the ESOP owns at least 30 percent of the company's stock after the sale and the selling shareholder reinvests or "rolls over" the proceeds into qualifying replacement securities.) Lenders will usually demand that these replacement securities be of investment grade. Further, they will attempt to establish an advance rate on those securities based upon the portfolio mix. Bonds will have a significantly higher advance ratio than stocks because they are less volatile. In some cases, there might be an opportunity for the negotiation of the elimination of any advance formulas with the lender at risk for market fluctuations.



As mentioned previously, lenders do not like to be at risk. If they have agreed upon the elimination of advance ratios, they will probably mitigate market risk by seeking personal guarantees of selling shareholders and key managers. The selling shareholders should do whatever is necessary to avoid this guarantee. Not because he or she does not believe in the ongoing ability to service the debt, but rather that the risk will outweigh the shareholders' historic ability to control the company going forward. Knowing that extrication from the business is the goal and the future control of the company will lie in the hands of management, the guarantees of the key managers should be offered, if not already asked for, by the lender.

Key managers might not be happy with providing these guarantees. The inherent risk of guaranteeing the loan can be mitigated by improving the returns to these key managers. This can be accomplished by utilizing non-qualified forms of equity incentives such as incentive stock options, or restricted shares, or a combination of both. These equity incentives should be structured into the transaction prior to the presentation of the deal to the lender. Available cash flows would also need to be re-evaluated as cash bonuses will be required to satisfy the tax implications of these equity incentives. Further analysis should be done to understand the dilutive effect these equity incentives have on the ESOP and other shareholders. Finally, key managers should be able to negotiate dollar limits on their guarantees to the satisfaction of the lender.

Capital

Since a company that has had an ESOP in place understands the negative effect of this debt on the balance sheet, it is prepared for the significant erosion of the balance sheet that occurs after a second stage deal. The successful paydown of the original ESOP debt is part of the motivation for entering into the next transaction. This established track record of managing the debt is an integral part of lender approval and the continued pursuit of the business owner's exit strategy. Caution must be exercised to assure the deal size does not preclude the company from growing its business just to buy out a selling shareholder. The working capital requirements of the business must be considered along with any capital expenditures that must be made in order to keep the company on its historic successful path.

The size of the second stage transaction combined with the need to maintain sufficient levels of working capital might necessitate the use of mezzanine financing to complete the transaction. Mezzanine financing can be composed of subordinated debt and/or equity. Subordinated debt requires high coupon rates with the possibility of equity return enhancements to bring the lender's yield to a range of 20 to 25 percent. There are several coupon-only lenders; however, they still require a similar yield. There are occasions when the selling shareholders are in a position to be the subordinated debt lender for the deal. They are usually willing to be more flexible on the interest rate (a yield range of 12 to 17 percent) and amortization. The amortization of this debt can be fairly flexible and may include interest only for a period of time followed by up to a ten-year amortization schedule with a balloon payment in either year five or year seven. In most cases, the subordinated debt lender seeks to be out of the picture in five- to seven-year time frame. This means the company must be prepared to refinance this debt in a similar time frame.

Equity investors seek returns on their investments of 30 to 40 percent and maintain similar time frames of three to six years to effectively exit their investments. The company must be prepared to meet the investor's exit requirements. If the



company's growth requirements are such that additional non-productive debt cannot be made available, an initial public stock offering or the outright sale of the business may be considered. If the company is not performing well and the investors still require an exit strategy, an outright sale of the business might be the only course of action.

The transaction should also consider the need to acquire any additional shares from other shareholders in subsequent transactions and/or the repurchase of shares from former employees who will exercise their put options as a result of their former participation in the ESOP.

The need for the lender to understand the repurchase liability at the time of the second stage deal is imperative due to the need to fund for the repurchase. If there is no cohesive policy for managing this liability, a lender may or should request that a repurchase liability study be performed and that the board of directors establish a plan for funding the repurchase. Cash flows will obviously need to be reassessed if repurchase liabilities are substantial. Further, the board of directors should address how the shares will be repurchased, as it will affect the capital structure going forward. Shares can be repurchased through the trust, thereby recirculating the shares and maintaining the existing ESOP percentage ownership, or by the company with after-tax dollars, which will place repurchased shares in treasury and over time dilute ESOP ownership.

THE BORROWER'S PERSPECTIVE

Most of the previous comments have been focused on what a lender considers important to complete a second stage transaction; however, it is important to consider the borrower's perspective as well. The leveraged ESOP is a tax advantaged form of recapitalization that has certain advantages over traditional forms of debt utilized in family/management buyouts. The implementation of a second stage ESOP that will most certainly make the company majority owned by the ESOP carries with it the long term "baggage" of issues, such as whether or not a company can achieve its growth objectives and still provide an adequate rate of return to the employee owners. If the continued incorporation of debt on the balance sheet is part of the company's long-range goals, can the company survive and thrive? If not, the shareholders should closely examine other exit strategies to determine their applicability. The few exit strategies available to the business owner are:

1. Sell to key managers/family members

The implementation of an ESOP demands that the company make an effort to create a culture of employee ownership. There are many successful stories of this taking place; however, in some companies the evolution of this culture does not meet the expectations of the principal shareholders. Consequently, these shareholders feel that the company might be better off in the hands of one or two key people. This means the key individuals will be in a position of control and will want to put together a transaction that meets their objectives as well as those of the selling shareholders. From the selling shareholders' perspective, a management buyout satisfies their desire for one or two people to control the business and theoretically see the business to the next generation. On the other hand, the proceeds received by the selling shareholders are immediately subject to capital gains tax. Further, the key people acquiring the business are burdened by debt that must be paid back with after-tax dollars; in some cases, because of the need for mezzanine financing, there is pressure from investor-partners who have return requirements that must be satisfied. A management



buyout carries with it greater cash flow pressures for companies that need to be recognized by all parties. The alternative can mitigate some of those pressures by incorporating the ESOP into the second phase transaction. For example, a company with an ESOP that owns 30 percent of the outstanding stock can bring the ESOP up to the 49 percent level as part of the second stage deal. The key people can contractually acquire the balance, giving them the control that they were seeking. The selling shareholders will receive a portion of their proceeds that is immediately taxable and a portion under which they can elect tax deferral under Section 1042. This combination can ease some of the cash flow pressure due to pre-tax contributions made to satisfy ESOP debt. The important idea to remember is that ownership breakdown percentages can be combined in order to facilitate a transaction that meets everyone's objectives.

2. Sell to the public in an Initial Public Offering (IPO)

Many private business owners desire to take their companies public. This is a strategy worth considering if the company is following a very strong growth path (or has the potential to do so) and has a niche (meaning it has a good story to tell investors), which requires the raising of capital. It is a questionable strategy if considered as a means to facilitate an exit strategy. After all, it is difficult to attract investors to situations where the principal shareholders are seeking to exit the business. Even if situations arise where shareholders may be able to create some liquidity, these shareholders will carry restrictions on the sale of their securities to the public – they must wait at least one year and then are limited to selling a very small percentage of their holdings over a specific time frame. The marketplace will also place restrictions on the selling shareholders by way of the daily trade volume exhibited by the stock. The smaller the “float,” the less ability the shareholder will have to sell significant amounts of shares in the market.

Timing for the issuance of an initial public offering can fall outside the desired time frame of selling shareholders. It is not unusual for offerings to be planned for up to two years in order to create and promote interest in the company. Even after the company's stock is publicly traded, continuous efforts must be made to promote the stock with analysts and market makers to avoid “pink sheet never-never land.” The requirements of consistent corporate promotion and the uncertainty of the recognition of those efforts can play havoc with personal liquidity objectives and estate planning.

With these negative points having been made, there have been numerous situations during the last several years wherein companies with ESOPs have successfully gone public. These companies have solved their need for additional capital and laid a strong foundation for future growth. Further, by going public, these companies have eliminated the repurchase liability incurred by the put option inherent with ESOP companies. These companies, upon death, disability, termination or retirement of an ESOP participant, can now distribute the stock and allow the marketplace to price the stock and provide liquidity.

3. Sell the business outright

As previously mentioned, there are ESOP companies that fail to develop an employee ownership culture and responsible management team – an objective that was originally desired by the selling shareholder(s) in the initial transaction. Assuming these shareholders remain in a control position, they can make an informed decision to sell the business to an unrelated third party. This decision can be quite difficult to implement because the sale of the business can be highly



emotional. This might be exaggerated by the fact that these shareholders expected employees and managers to embrace an ownership culture and they failed to do so.

It is true that in today's active merger and acquisition market, companies are being sold for significant multiples of earnings. This allows the selling shareholders to realize a significant amount of cash today without having to manage through the leverage incurred by recapitalizing the company through another ESOP phase or management buyout. Hopefully, synergies between a third-party buyer and the company can provide the ongoing company with long-term competitive strengths. The downside to the selling shareholders will be the reality that they will no longer be able to participate in any further value of the company and a buyer of the company will often not guarantee the retention of the current employees.

CONCLUSION

The implementation of a second stage ESOP transaction requires a great deal of analysis and reflection. The analysis of the company's ability to enter into a second stage transaction will be predicated on an objective look at the cash flow, collateral and capital of the company. The review will revolve around the subjective assessment of the character of company management.

Honesty with yourself and your managers should dictate the process of moving forward with the ESOP exit strategy. The selling shareholders should implement a strategy that is "right" for their particular situation, not a strategy that pleases your employees and ignores the objectives of the selling shareholders. The combination of sound and objective corporate finance advice with the reflection demanded of the situation will dictate the success or failure of a second stage ESOP transaction.

