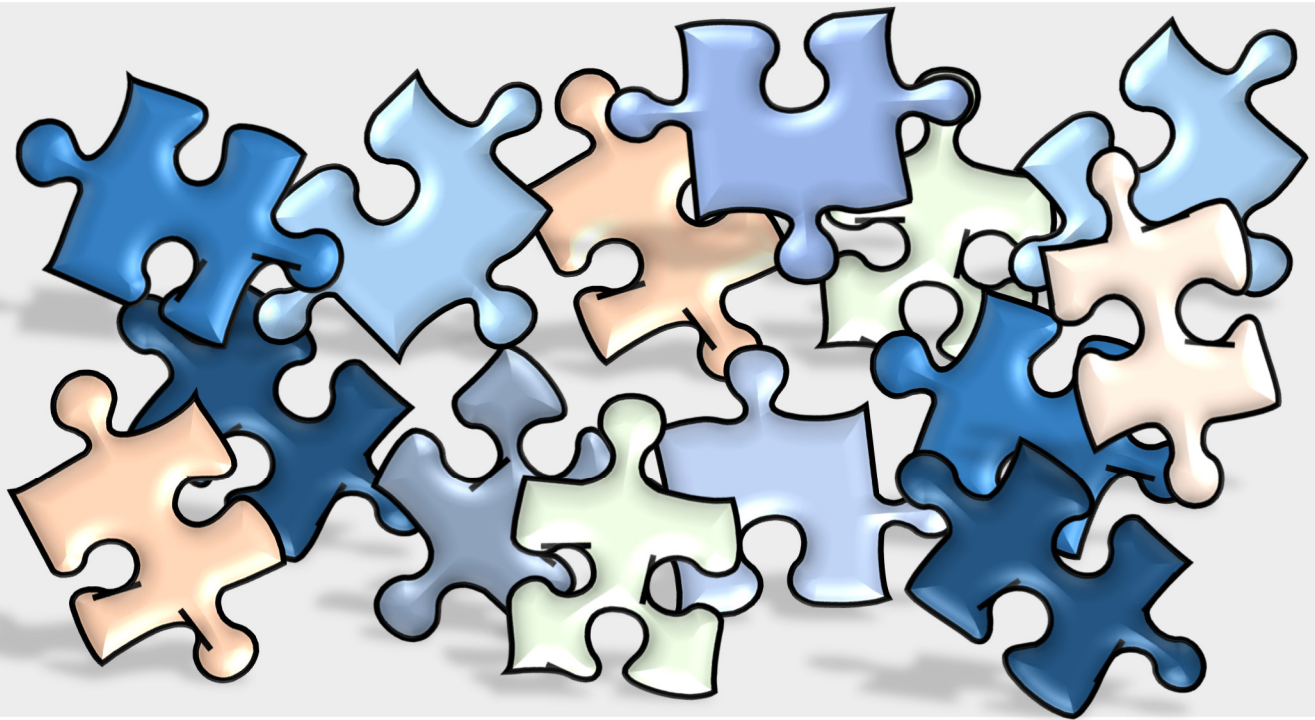


INTRODUCTION TO THE ESOP BUYOUT

WHITEPAPER | MAY 2017



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The ESOP buyout is a creative and flexible transaction structure that allows shareholders to generate liquidity through a buyout of their stock in a tax-advantaged manner, while allowing employees to share in company ownership at varying levels.

Introduction

An employee stock ownership plan (ESOP) is a tax-qualified defined contribution employee benefit plan that invests primarily in the stock of its sponsoring company. Structured as a management or shareholder recapitalization, the ESOP buyout can be a compelling liquidity mechanism for company owners/shareholders while offering numerous economic and tax benefits to the sponsoring company, selling shareholders and employees.

Although an ESOP provides unique ownership opportunities for employees, it also creates a market for the stock of closely held company owners/shareholders. Shareholders are also able to defer and potentially eliminate taxes on capital gains arising from the sale of their ownership interests to an ESOP under certain conditions.

Moreover, the ESOP provides unique and flexible financing options that allow a company to finance the buyout of departing owners while generating significant corporate tax incentives. In this regard, the ESOP buyout can be used as a corporate finance tool to recapitalize the company.



There have been over 10,000 ESOPs implemented in the U.S. since inception in 1956. Various rulings and acts from 1974 to 2001 have expanded the overall benefits and tax advantages to company owners, thus making the ESOP an appealing alternative.

The Shareholder's Dilemma

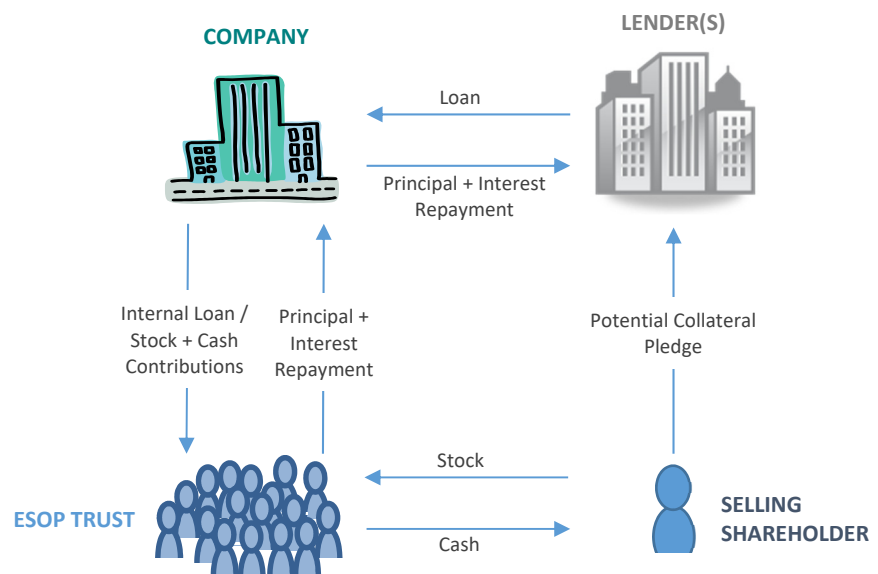
Owners and investors of closely held companies work hard and take big risks to grow their companies and generate value. But often, much of a shareholder's net worth is tied up in the business. Generating liquidity can sometimes be difficult or time-sensitive, and options may be limited when selling shares of a closely held corporation. Selling to a third-party buyer, often a larger competitor, might not yield the intended results given the length of process, extensive diligence and overall risks. In addition, other traditional liquidity options might not be feasible, are too challenging, or do not yield the desired proceeds.

Alternatively, an ESOP buyout/recapitalization may be a solution to generating liquidity more efficiently with greater certainty and a more attractive economic outcome. And more importantly, selling shareholders are able to diversify their net worth while still maintaining a partial equity interest if they desire.

An ESOP buyout offers meaningful funding and structuring flexibility through a mix of third-party and seller-based financing, either upfront or over time, in multiple transactions depending on a shareholder’s particular needs.

ESOP Buyout Structure

An ESOP can be established through direct cash or stock distributions over time, or alternatively, through borrowed funds in an upfront transaction—often referred to as a “leveraged” ESOP. In a leveraged ESOP transaction, one or more shareholders will typically sell all or a portion of their stock to the ESOP at fair market value. Based upon the amount of equity being sold, the transaction is financed with new debt from a third-party lender or, in some cases, from the owner directly. The ability to use owner (seller-based) financing provides added flexibility and enhanced income potential to the shareholder.



The leveraged ESOP is uniquely structured to achieve a particular shareholder’s goals and the Company’s desired after-tax cash flows. Moreover, the debt is structured to accommodate flexibility in amortization and allow for organic company growth. And there are compelling tax savings associated with financing the ESOP using a leveraged structure.

The shareholder can choose to sell its equity interests in one upfront transaction or gradually over time. In the case of an owner/CEO, irrespective of the percentage of equity sold, the owner may continue to retain control of day-to-day operations in his current position or transition control to other senior management.

Sponsoring companies benefit from the tax deductions associated with ESOP-related principal, interest and dividends. Moreover, if structured properly, selling shareholders can indefinitely defer capital gains taxes on their proceeds resulting in greater after-tax proceeds compared to other alternatives.

Tax Advantages

Unlike other types of buyouts, an ESOP buyout can generate some very attractive and compelling tax benefits for the sponsoring company, participating employees and selling shareholders.

When structured properly, the ESOP creates recurring corporate tax incentives for the sponsoring company. Subject to certain limits, tax deductions may include principal and interest paid on ESOP debt obligations, as well as dividend contributions (although dividends may be subject to AMT). These corporate tax deductions result in greater relative operating cash flow, reduced taxes, and more rapid growth in equity value. The reduced corporate tax liability allows the company to free up more cash flow to reduce debt or fund internal growth initiatives.



The accounts of employees who participate in the ESOP will grow in value on a tax-deferred basis as the company's value increases. Departing employees who sell their stock back to the company may roll over such proceeds to a qualified retirement plan (on a tax-free basis).

Selling shareholders are also able to take advantage of powerful tax incentives if certain criteria are met. Under §1042 of the Internal Revenue Code, selling shareholders are eligible to indefinitely defer capital gains taxes under the following general conditions:

- The ESOP must own at least 30% of the company's equity post-transaction and generally must retain the stock for at least three years following its purchase;
- The company must be a C-Corporation (or have converted to a C-Corp.) immediately before ESOP implementation;
- Each selling shareholder must have owned his stock for the preceding three years (irrespective of entity type); and
- The equivalent amount of sale proceeds must be reinvested, within a reasonable time period, in qualified replacement property (QRP), which is defined as debt or equity securities of qualifying domestic companies.

The selling shareholder determines what percentage of his sale proceeds will be invested in QRP and thus subject to tax deferral. Through the use of a 1042 margin loan, the large majority of the amount invested in QRP can be advanced to the owner without penalty or taxation. The annual net interest cost of the 1042 margin loan (offset against interest income on the QRP) varies over time but is often less than 100 basis points, which is meaningfully lower than the tax savings.

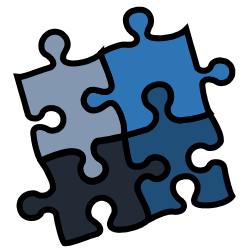
The ESOP buyout provides employees the ability to become indirect owners, upon vesting, through a tax-advantaged retirement savings vehicle that can increase in value over time as the company's value increases.

Employees

Similar to a 401(k) plan, the value of the ESOP grows over time on a tax-deferred basis as the value of the underlying investments (in this case, the sponsoring company's value) increases. Moreover, an ESOP also creates powerful productivity incentives as employees become indirect owners of the company at no upfront cost to them. It's no surprise that companies with ESOPs have been proven to outperform their peers.

Employees are able to participate in the ESOP if they meet certain qualifications. In general, participating employees are often 21 years of age or older with one or more years of company service and at least 1,000 hours of service within 12 months of ESOP initiation. Independent contractors (1099 employees) are not eligible.

Following ESOP implementation, shares of stock are initially held in a suspense account within the ESOP trust. Over time, as the company makes ESOP contributions and the ESOP pays down its debt, shares are released to individual employee accounts. Over time, employees become indirect owners of the company subject to a vesting schedule.



When employees retire or leave the company, their ESOP stock is typically repurchased by the company within a defined timeframe. The company has a "repurchase obligation" that is determined by multiple factors such as the ESOP's vesting schedule, ages of the employees, estimated repurchase valuation, etc. Since this obligation can grow over time, the company will need to plan accordingly.

At the owner's discretion, the company may also establish a separate management incentive plan (MIP) that provides senior executives with additional equity incentives. The MIP is separate from the ESOP and subject to certain limitations.

ESOP Buyout Considerations

There are a number of factors to consider when choosing to implement an ESOP. It is important to work with a corporate finance advisor who can properly structure the ESOP and manage the lender and valuation diligence processes. In addition, the advisor should have existing relationships with ESOP lending institutions, legal counsel and valuation experts, and have possess leveraged buyout/recapitalization experience.

Compared to other liquidity alternatives, the ESOP buyout can offer substantially greater advantages including flexibility in structure, speed to close, greater after-tax proceeds, company tax incentives, and retained control, among many other factors.

ESOP Buyout Considerations (cont.)

One of the key attributes of the ESOP buyout is the company valuation. The basis for the valuation is a fair market appraisal by an experienced, independent valuation firm. Such appraisal forms the basis of value in the initial sale of stock to the ESOP. Every year thereafter, the company must obtain a valuation by an independent appraiser.

At the time of ESOP implementation, a trustee must be hired by the company to represent the ESOP employee participants. The trustee is appointed by the company's board, which is typically controlled by the owner. For corporate matters requiring a vote, the trustee will typically vote on behalf of the employees without specific direction. For major corporate issues, such as change of control, voting preferences/responsibilities may pass through to the individual employees.

Comparison to Other Alternatives



There are a number of internal and external liquidity alternatives available to owners of closely held companies. Options such as a sale of stock back to the company or to senior management often require outside financing and do not provide corporate or shareholder tax incentives. In addition, a third-party company sale or buyout/recapitalization is highly dependent on outside variables such as buyer demand and valuation levels, negotiating leverage and posturing, and many other risks and uncertainties.

Compared to these alternatives, however, the ESOP recapitalization may provide some compelling advantages:

- Speed—ESOP implementation generally takes two to four months;
- Structure—owner flexibility in transaction structure and financing options;
- Confidentiality—no sharing of information with competitors;
- Stability—reduced customer concerns and employee uncertainties; and
- Governance—minimal changes in post-transaction control without outside conflicts of interest or disparate agendas.

Finally, the ESOP buyout may generate higher net after-tax proceeds on both a cumulative and present value basis, compared to other exit options, including an internal company buyback, external sale or third-party recapitalization.

The ESOP process begins with a highly detailed feasibility analysis and valuation, where multiple ESOP structures are analyzed in depth based on various operating assumptions, goals of the selling shareholder(s), and any limiting factors.

The Process

Once a decision has been made to formally evaluate the ESOP alternative, there are several key steps in the process:

1. *Initial Feasibility Analysis and Valuation.* A qualitative and detailed analytical analysis of the ESOP buyout is undertaken, utilizing multiple transaction structures to determine the after-tax consequences, risks and advantages. As part of this exercise, Opus works closely with management to construct detailed financial projections with supporting assumptions as well as a full company valuation. A third-party fair-market valuation is also initiated.
2. *Supporting Due Diligence Materials.* A confidential information memorandum (CIM) is constructed with supporting due diligence materials. These materials, which include much of the information from Step 1 (above), are utilized by external lenders, third-party appraisal firm and the ESOP trustee.
3. *Lender and ESOP Trustee Approvals.* Direct communication with lenders and other constituents is initiated to evaluate the transaction and agree on the proper capitalization and structure. Legal documentation is also initiated.
4. *Closing Process.* Employees are notified and are provided the opportunity to formally participate, transaction documents are finalized, and funds are wired.

Frequently Asked Questions

How do I know if an ESOP is worth consideration?

The determination of which type of ESOP buyout to implement, and how it is specifically structured, is dependent upon the corporate entity type, goals of the selling shareholder(s), and the amount of proceeds being sought, among other aspects. The ability to structure an ESOP is based on multiple factors, some of which include the company's pre-tax profitability and outstanding debt level, equity ownership composition, employee makeup (number of employees, compensation level, etc.), as well as other company-specific attributes.

It is important to work with an advisor who can identify the key drivers of an ESOP transaction based on a particular company's characteristics and limiting factors. Given that the ESOP is a customized solution, discussing a company's situation in depth with an advisor is the most prudent first step in determining whether consideration of an ESOP is warranted.

Frequently Asked Questions (cont.)

In order to qualify for an ESOP buyout, does the company need to be a certain entity type?

Any company can structure an ESOP as long as it is a C-Corporation or S-Corporation immediately before ESOP implementation. A limited liability company (LLC), for example, can convert to a C-Corp. or S-Corp., depending on its specific circumstances, thus offering significant flexibility with regard to implementation and structure. In some cases, an S-Corp. may wish to convert to a C-Corp. immediately before implementation for a number of reasons, which include the ability to defer income taxes on capital gains from proceeds. An advisor will be able to explain the specific advantages and considerations of each scenario.

How does a C-Corp. ESOP differ from an S-Corp. ESOP?

Both C-Corp. and S-Corp. ESOP structures offer varying advantages and disadvantages depending on the circumstances. Because each company and specific shareholder situation is unique, and because there is significant flexibility in how to structure the transaction, multiple scenarios need to be modeled in detail to determine the structure that provides the greatest risk-adjusted advantages.

A C-Corp. ESOP offers both selling shareholders and sponsoring companies the opportunity to reduce or defer income taxes. With regard to individual tax benefits, if the ESOP is structured properly, the selling shareholder may indefinitely defer capital gains taxes on transaction proceeds. From a corporate tax perspective, a C-Corp. may deduct principal payments on ESOP-related debt and dividend payments up to a threshold, thus reducing its pre-tax income and corporate tax liability. In addition to these deductions, the C-Corp. can deduct an unlimited amount of interest expense associated with all of its debt obligations.

While an S-Corp. ESOP does not provide the same tax deferral benefits to selling shareholders as in the C-Corp. scenario, it does provide other noteworthy tax benefits. Similar to a C-Corp. ESOP, an S-Corp. may deduct principal and interest payments on ESOP-related debt up to a threshold, thus reducing pre-tax income and requisite shareholder tax distributions. An S-Corp. ESOP is not required to pay its pro rata, shareholder portion of federal income taxes (and, in many cases, state income taxes) since the ESOP is considered a tax-exempt entity. In the case of a 100% ESOP-owned S-Corp., there are no income tax distributions made, and much of a Company's pre-tax income is retained internally (except for the necessary funding of repurchase obligations). As a result, cash flow that would otherwise be distributed for tax purposes is often used to aggressively pay down debt or invest in growth initiatives. In this case, growth in shareholder value can often be accelerated.

Frequently Asked Questions (cont.)

Under what circumstances would selling shareholders be eligible to defer taxes on capital gains?

As mentioned above, a C-Corp. ESOP, if structured properly in accordance with §1042 of the Internal Revenue Code, allows the selling shareholder to indefinitely defer capital gains taxes on transaction proceeds if invested within 12 months following the transaction (or the equivalent proceeds three months before the transaction) in low-risk, low-yield U.S. securities that are commonly referred to as qualified replacement property (QRP). While the yield on QRP is low, the selling shareholder can often borrow against the QRP at a high advance rate and therefore re-invest or use the proceeds however he/she sees fit. If the selling shareholder were to pass away while invested in QRP under §1042, his/her invested proceeds would receive a tax-free, step-up in basis prior to being distributed to heirs.

In some cases where states have high state income taxes, the total capital gains (including other related net investment income taxes) blended tax rate can approximate 30% or more. Therefore, the additional net proceeds, which would otherwise be paid in taxes, makes this ESOP structure very compelling compared to other traditional alternatives.

What advantages does an ESOP buyout provide compared to a third-party sale or majority recapitalization (private equity buyout)?

An ESOP buyout allows selling shareholders the ability to structure a transaction that is highly flexible, taking the form of a minority or majority recapitalization, or a 100% sale. The key advantages of an ESOP compared to other more traditional third-party exit transactions include the following:

- For selling CEOs, the ability to maintain full control of day-to-day operations, most corporate decisions, and the makeup of the board of directors, irrespective of the amount of equity sold
- Flexibility in what percentage of the company is being sold to the ESOP, how the transaction is financed (third-party financing, company cash, seller notes, etc.), the ability to put in place warrants or synthetic equity as an enhancer to selling shareholders, etc.
- Potential individual tax savings through the deferral of capital gains taxes (for qualifying C-Corp. ESOPs) resulting in greater after-tax proceeds
- A transaction structured as a sale of stock versus a sale of assets
- Reduced corporate taxes as a result of ESOP-specific corporate tax deductions
- Employees become owners (on a tax-deferred basis) and overall productivity tends to increase

Frequently Asked Questions (cont.)

How does an ESOP buyout compare to an inside sale of stock to other shareholders or senior management?

Whereas an ESOP buyout allows more flexibility, control and negotiating leverage for selling shareholders, the inside sale may be subject to ongoing negotiations between seller(s) and buyer(s) on future valuation, governance/control and major corporate decision-making. In addition, an inside sale often requires the purchasers to use after-tax proceeds to acquire the stock and may also require 100% financing from the selling shareholder(s). An inside sale would not allow the company to maximize tax deductions as is the case with an ESOP, nor would it allow for tax deferral of shareholder proceeds. For these reasons, an ESOP will most likely provide more compelling qualitative and economic advantages than an inside sale.

Does it matter that a shareholder can defer taxes upfront through an ESOP structure since he/she will be paying taxes eventually on any future exit proceeds?

Compared to a transaction that is taxed upfront, total proceeds from a tax-deferred ESOP structure are greater by as much as 30% (or more) of total pre-tax proceeds. Therefore, there is an opportunity to invest 100% of pre-tax proceeds upfront through QRP, thus generating returns on greater amounts of principal over more time, versus the alternative. Moreover, selling shareholders have the option to fund a portion of their buyout through seller notes, which typically pay a rate of interest of 8% to 12% in addition to potential additional return from warrants or synthetic equity. For these reasons, an upfront ESOP transaction can provide greater economic value.

Why should a shareholder hire a corporate finance advisor to analyze, structure and complete the ESOP...why not just work with a bank directly?

Because of the flexibility in structuring an ESOP buyout to meet the goals of selling shareholders as well as the unique operating performance of each company, care must be taken to analyze various alternatives. The right corporate finance advisor can proactively and creatively structure the most advantageous transaction, including the appropriate level and type of debt financing, among various structures that are analyzed. The advisor will also work with multiple third-party lending sources in order to implement the most preferred structure at the most favorable economic terms. The advisor manages the process from start to finish, coordinates communications with all constituencies (owner, lender, attorney, ESOP trustee, etc.), and represents the best interests of the selling shareholder(s). Having an advisor that has significant leveraged recapitalization experience working on the selling shareholders' behalf allows for a more seamless transaction with fewer negative surprises.

Frequently Asked Questions (cont.)

Is a company required to borrow third-party financing to finance an ESOP buyout? How much can be borrowed? Can an ESOP be structured if a company is adverse to large amounts of debt?

An ESOP can be funded by any source of capital, including outside equity or cash on the balance sheet. However, many ESOPs are funded almost entirely through debt, including third-party bank debt, third-party subordinated debt (mezzanine financing) and/or seller-based financing. Financing an ESOP buyout with debt allows for upfront and future liquidity to shareholders on a corporate tax-advantaged basis (i.e. using available pre-tax income that would otherwise be used to pay taxes).

In low-rate environments, the use of third-party financing is a particularly attractive option. Third-party lenders will often lend primarily on a company's collateral value, and secondarily, if large enough, on EBITDA (earnings before interest, taxes, depreciation and amortization) and operating cash flow. Any additional financing needs are typically sourced through subordinated debt (third-party or seller-based). The use of seller-based financing can be attractive given the inherent rates of interest, flexibility of amortization, and the ability to use warrants or synthetic equity to further enhance the seller's returns and income. Irrespective of the type of debt utilized, there are significant corporate tax benefits available through the deduction of both principal and interest of ESOP-related debt. In this respect, utilizing debt to finance an ESOP can offer noteworthy benefits in terms of taking advantage of excess pre-tax income while still maintaining reasonable coverage ratios.

While we don't recommend that a company employ excessive debt, it is important to acknowledge both the advantages and risks to such a structure where there might be sizeable post-transaction debt on the balance sheet. The optimal capital mix and sourcing is based on a particular company's circumstances. In one case, it might make sense to use all third-party senior bank debt to fund the transaction. In another case, using a combination of third-party senior debt plus seller notes is most optimal. In some cases, financing the transaction with mostly seller-based financing is the only option available.

The use of seller-based financing, which is inherently more flexible and modifiable than third-party debt, can provide the cushion required to reduce risk to the selling shareholder(s) if future company cash flows are unexpectedly reduced. It is important to note that each company and situation is unique and should be evaluated accordingly by a corporate finance advisor that can analyze the risks and considerations, both quantitatively and qualitatively.

For More Information



Under the right circumstances, a leveraged ESOP buyout can provide some very compelling advantages, including structuring flexibility, maximizing after-tax liquidity, and maximizing corporate tax deductions. If you believe an ESOP transaction might be an alternative worth consideration, Opus Advisory Partners can provide you with more specific qualitative and analytical guidance to help you evaluate this decision.

For more information about the ESOP buyout and how it might apply to your specific needs, please contact Leland Miklovic, Managing Director, at (404) 476-4470 or lmiklovic@opusap.com.

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