



Is an ESOP Right for You?

Omaha, NE – October 9-10, 2019



Alternatives to an ESOP

Presented by:

Ted Margarit

Chartwell Financial Advisory

150 S. 5th Street, Suite 2700

Minneapolis, MN 55402

312-638-5656

ted.margarit@chartwellfa.com



CHARTWELL

Where to Begin

- Know your personal and company goals and objectives
- Understand the details of applicable strategic alternative(s)
- Select skilled advisors who can deliver your transaction – also those free from conflicts
- Ensure ALL your trusted advisors (e.g. legal, tax, estate, wealth, etc.) are involved

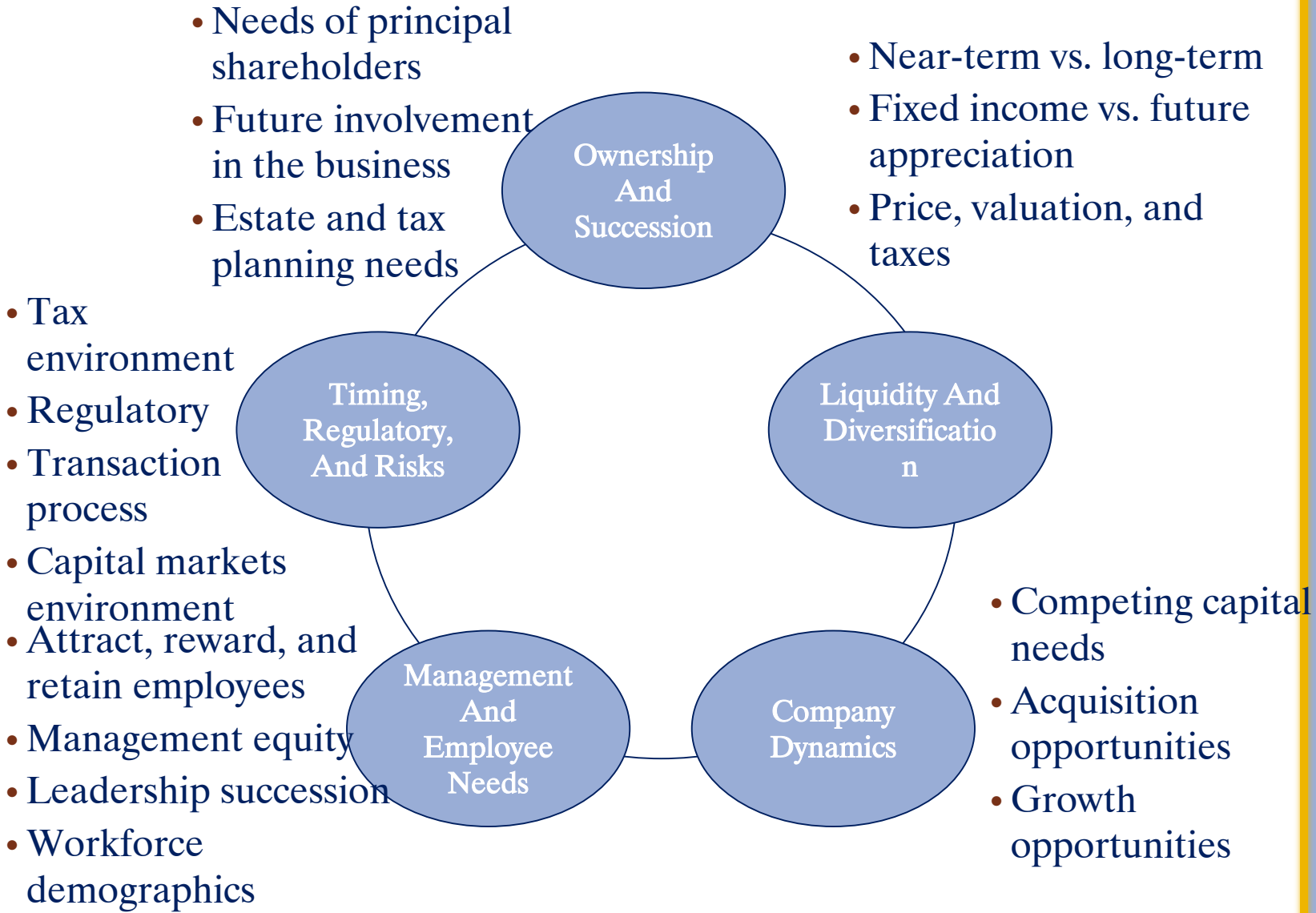


NCEO
NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP

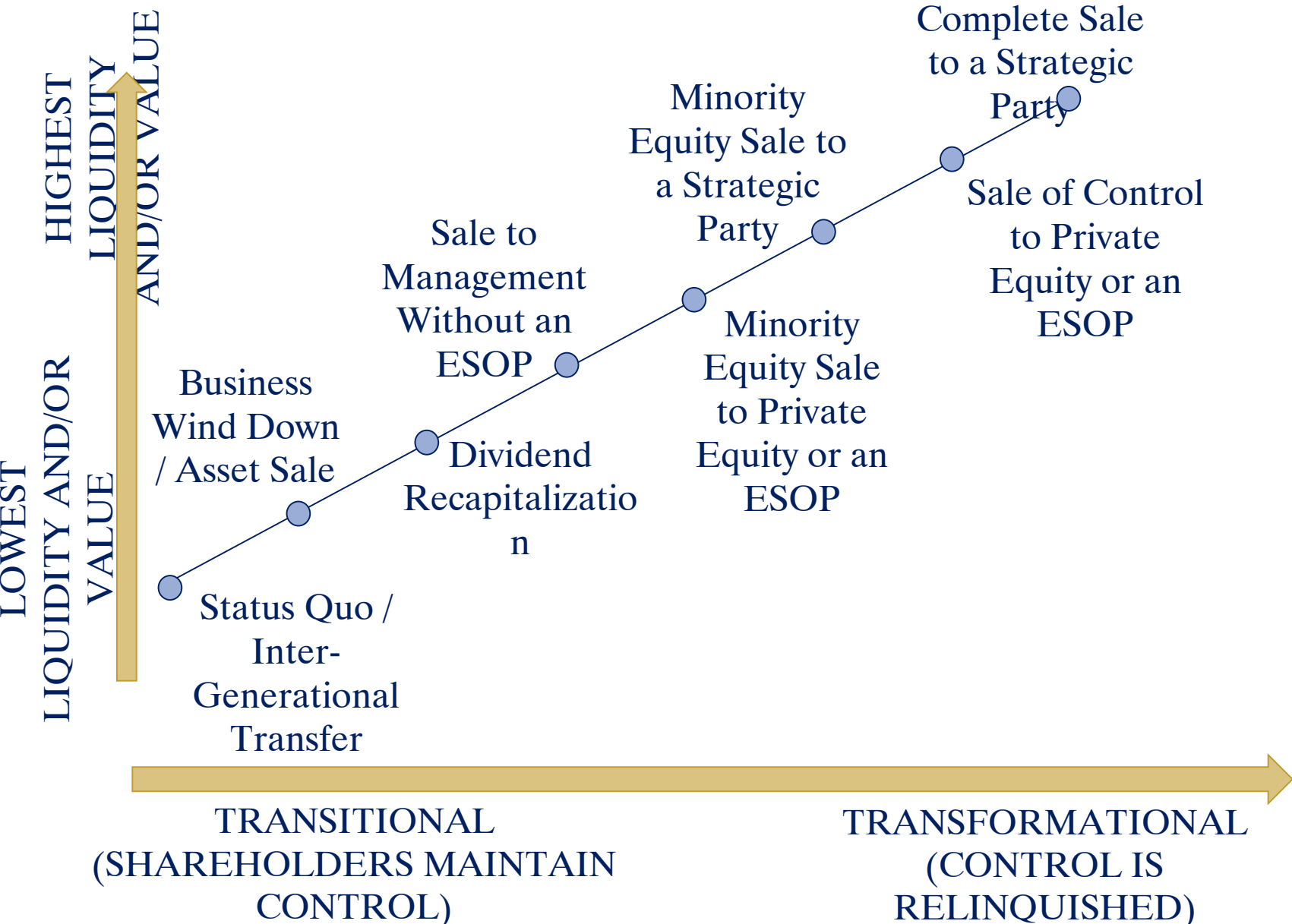
Know your Personal and Company Goals and Objectives



NCEO
NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP



Understand the available strategic alternatives



Where to Begin

Select skilled advisors who can deliver your transaction – also free from conflicts, unbiased to outcomes

- **Identify what expertise you need**
 - Corporate financial
 - Legal (corporate, ESOP, and estate)
 - Wealth management
 - Accounting (audit, tax, quality of earnings)
 - ESOP (trustee and third party administration)
- **How to ensure that you have assembled the “best” team possible**
 - Referrals from trusted sources
 - Check references from prior relevant experience (industry, chosen strategy, size, etc.)
 - Be aware of potential conflicts of interests and/or bias towards a particular outcome



NCEO
NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP

Where to Begin



Work To Minimize “Backend” Surprises On The “Front End”

- **How “clean” are your financial statements?**
 - Are they reviewed or audited? If so, how long have they been so?
 - Are your internal systems and controls up to date? Do they provide visibility into the enterprise down to the SKU, customer, location, etc.?
 - Do the shareholders receive additional, perquisites from the business or have related party transactions (cars, credit cards, real estate leases)?
- **Consider conducting a Quality of Earnings analysis**
 - What form of capital is desired, how complicated your company’s financials are, the extent of EBITDA “add backs”, etc.
 - When choosing the firm to provide this service, evaluate who is the intended audience and ensure that they will respect the firm’s brand

Where to Begin

Work To Minimize “Backend” Surprises On The “Front End” Con’t.

- **Set clear transaction goals and objectives upfront (Shareholder and Company)**
 - Establish what you want up front and set clear expectations for your advisors/buyers/investors to allow them to meet these objectives
 - Beyond price, most goals are achievable, communicate on the front end to avoid surprises
 - If multiple shareholders discuss transaction considerations openly to avoid disagreement late in the process
- **Hit your numbers!**
 - Nothing hurts a process more than missing budgeted results or presenting unreliable data
 - Providing aggressive and/or unsupported projections and uncollaborated data are counterproductive and detract from management’s credibility with investors/buyers



NCEO
NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP

Strategic Alternatives



Shareholder Ownership Alternatives

- **Complete Sale to Strategic Party**
 - Sale of all equity to another operating business to realize synergies that supports a premium price
 - Seller(s) generally have no further ownership in, or control over, the business
- **Sale of Control to Private Equity (“LBO”)**
 - Sale of more than 50% of equity in exchange for a price reflecting a controlling interest value
 - Seller(s) maintain some equity ownership and involvement, but not control
- **Sale of Control to an ESOP** (if desired, it is possible to sell 50%-100% and retain control)
 - Sale of more than 50% of equity in exchange for a price reflecting a controlling interest value
 - Seller(s) maintain some equity ownership and involvement, but retain more control than Private Equity

Strategic Alternatives

























NCEO
NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP

Shareholder Ownership Alternatives *Con't.*

- **Minority Equity Sale to Private Equity or an ESOP**
 - Sale of less than 50% of equity in exchange for a price reflecting a minority interest value
 - Seller(s) maintain significant equity ownership and control
- **Sale to Management Without an ESOP (“MBO”)**
 - Management purchases the business using primarily seller financing
 - Seller(s) maintain significant equity ownership and control
- **Dividend Recapitalization**
 - Company obtains a loan to provide a distribution to shareholder(s)
 - Seller(s) maintain equity ownership and control
- **Status Quo**
 - Stay the course

Considerations when selecting a transition strategy: Outcomes and Ranking of Alternatives



| Consideration | ESOP | Strategic Sale | PE Sale |
|------------------------|---|--|---|
| Valuation |  |  |  |
| Taxes |  |  |  |
| Liquidity at Close |  |  |  |
| Liquidity in Future |  |  |  |
| Post-Close Governance |  |  |  |
| Legacy |  |  |  |
| Management & Employees |  |  |  |
| Post-Close Regulatory |  |  |  |

What things should I consider when selecting an ownership transition strategy?

Pros of a Strategic Sale

- Liquidity for Sellers
- Sellers will be able to walk away from running the business
- More available equity capital may enable growth opportunities for the business

Cons of a Strategic Sale

- Significant business disruption during sale process
- Sharing confidential business information with competitors/customers
- Sellers and management likely lose control
- Employees may lose jobs
- Community may lose employer
- Potential risk of increased leverage limiting growth opportunities
- No financial benefit for non-shareholders



What things should I consider when selecting an ownership transition strategy?

Pros of a Private Equity Sale

- Liquidity for Sellers
- Sellers may be able to walk away from running business
- More available equity capital may enable growth opportunities for the business
- Opportunity to roll equity into new Company

Cons of a Private Equity Sale

- Significant business disruption during sale process (and again in the future when resold by PE firm)
- Sellers/management likely lose control
- Management/employees may lose jobs
- Community may lose employer
- Risk of increased leverage limiting growth opportunities
- No financial benefit for non-shareholders
- No tax benefits for the company or selling shareholders



What things should I consider when selecting an ownership transition strategy?

Pros of Selling Control to an ESOP

- Achieve equal valuation to a private equity offer
- Maintain equity upside and, if desired, personal involvement in the business
- Tax, certainty of close, and cultural advantages for the Company and Sellers
- Preserves Company independence and legacy
- Likely preserves jobs vs. sale to a strategic or private equity acquirer
- Potential improvements in employee culture and productivity
- Advantages vs. competitors due to a more favorable corporate tax structure
- Positive recognition in the community for achieving employee ownership
- Potential deferral of capital gains through a Section 1042 rollover



What things should I consider when selecting an ownership transition strategy?

Cons of Selling Control to an ESOP

- Likely inability to realize full liquidity at closing, with the need to hold seller notes going forward
- Risk of increased leverage limiting growth opportunities
- Increased need to focus on corporate governance
- Cumbersome compliance requirements
- Potential for DOL and IRS scrutiny
- Professional and administrative expense (particularly for small companies)
- Lack of diversification for employee retirement accounts
- Potential employee issues if ESOP replaces other employee benefits



What things should I consider when selecting an ownership transition strategy?

Pros of a Minority Sale to Private Equity

- Partial liquidity for Sellers
- Benefit from operational expertise of a private equity firm and ability to improve management depth
- More available equity capital may enable growth opportunities for the business

Cons of a Minority Sale to Private Equity

- Sellers typically required to continue running business
- Significant business disruption during sale process (and potentially again in the future)
- Sellers/management share decision making with the investor
- Employees may lose jobs as the investor seeks to cut costs and strengthen operations
- No tax benefits for the company or selling shareholders



What things should I consider when selecting an ownership transition strategy?

Pros of a Minority Sale to ESOP

- Partial liquidity for Sellers seeking to exit business
- Maintain control, obtain cultural advantages, and provide certainty of closure to the Sellers
- 30%+ sale as a C-Corp allows for a Section 1042 election to defer capital gains taxes by the Sellers

Cons of a Minority Sale to ESOP

- Sellers do not realize full liquidity and maintain a majority ownership stake in the business
- Cumbersome compliance requirements
- Potential for DOL and IRS scrutiny
- Professional and administrative expense (particularly for small companies)
- Risk of increased leverage limiting growth opportunities
- Lack of diversification for employee retirement accounts
- Potential employee issues if ESOP replaces other employee benefits



NCEO
NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP

What things should I consider when selecting an ownership transition strategy?

Pros of a Management Buyout

- Ensured ongoing business continuity
- Higher certainty of closure due to friendly transaction
- Limited business disruption
- Sellers/management still control business

Cons of a Management Buyout

- If management lacks sufficient equity/debt financing, Sellers may need to hold a sizeable seller note or rollover equity
- Higher leverage could limit future flexibility
- Increased scrutiny of Company performance by Lender
- No financial benefit for non-shareholders
- No tax benefit for the Sellers or the Company



What things should I consider when selecting an ownership transition strategy?



Pros of a Dividend Recap

- Liquidity for Sellers and opportunity to diversify holdings
- Higher certainty of closure
- Limited business disruption
- Sellers/management still control business
- Tax savings on additional interest deduction

Cons of a Dividend Recap

- Dividend will be governed by debt capacity of business
- Additional debt obligation without additional cash flow
- Higher leverage could limit future flexibility and growth
- Increased scrutiny of Company performance by Lender
- No financial benefit for non-shareholders
- No tax benefit for selling shareholders

Questions ?



NCEO
NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP

Ted Margarit
Chartwell Financial Advisory
150 S. 5th Street, Suite 2700
Minneapolis, MN 55402
312-638-5656
ted.margarit@chartwellfa.com

