LEAVING YOUR LEGACY TO YOUR EMPLOYEES

AN INTRODUCTION TO EMPLOYEE STOCK OWNERSHIP PLANS

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One of the most important decisions a business owner will make is determining the future leadership and ownership structure of their company. While some employees can retire and enjoy the next phase of their life with minimal stress, a business owners' path to retirement is much more complicated.

Succession planning should be top of mind for business owners of all ages. However, running the day-to-day operations of the company will push succession planning to an "out of sight, out of mind" mentality, along with the emotional stress that may come with planning for the unknown future.

Entrepreneurs face several options for the succession of their company – handing the business down to children and/or family members, selling the company (including to a competitor), closing, or creating an Employee Stock Ownership Plan (ESOP). If an owner doesn't have eligible or qualified family members to take over the business or wants to experience a steady transition to retirement while remaining involved, an ESOP may be a perfect solution.

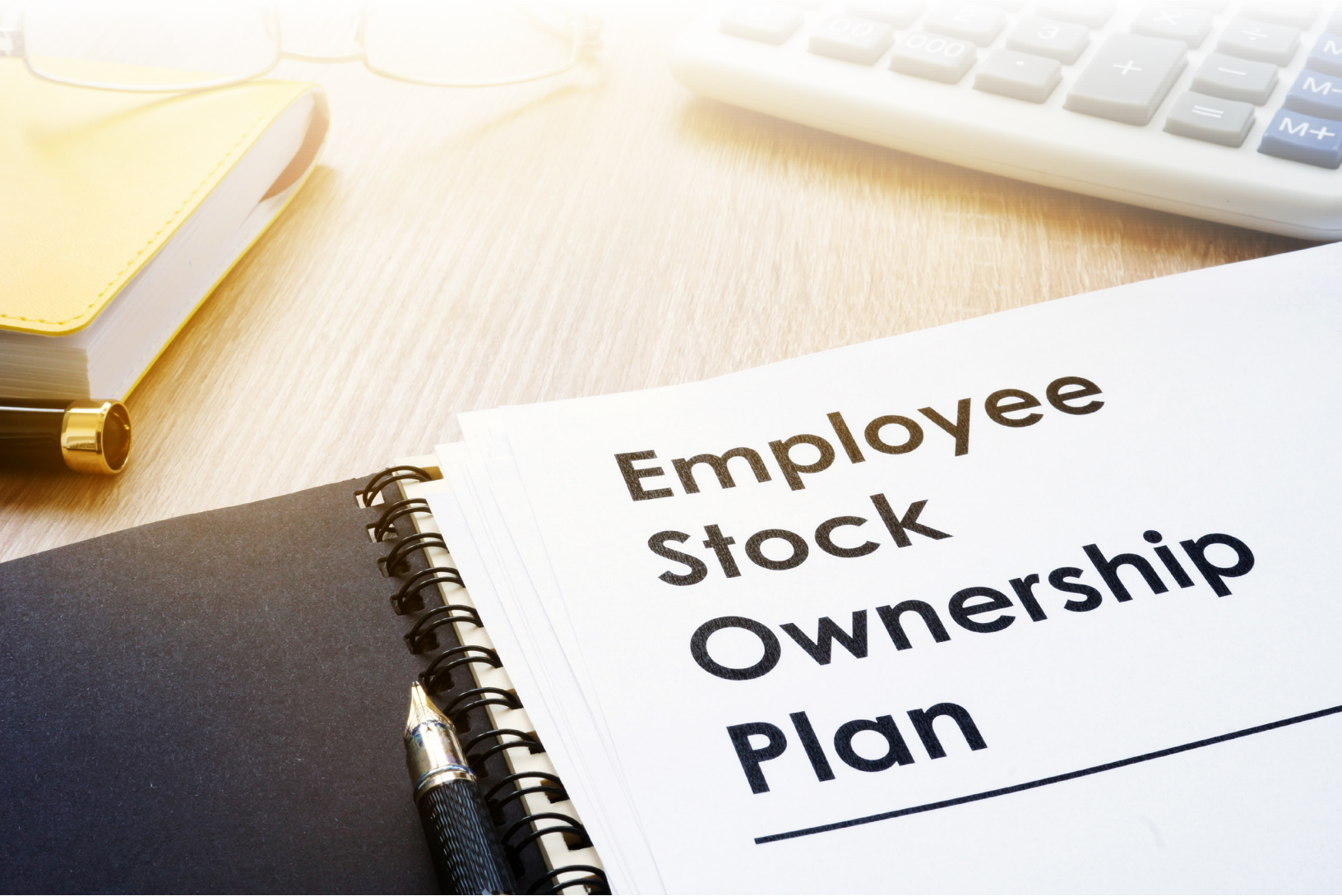
Owner's Involvement	Transition	Maintain Some Involvement	Employee-Friendly	Press Friendly
Gifting to a family member	Usually	Usually	Maybe	Maybe
Closing	No	No	No	No
Selling	Maybe	Maybe – on Buyers' Terms	Maybe	Maybe
ESOP	Flexibility	Yes	Yes	Yes

WHAT IS AN ESOP?

An Employee Stock Ownership Plan (ESOP) is a qualified retirement plan designed to invest primarily in the stock of the corporate employers. Simply put – a benefit plan for your employees will buy the company.

Since ESOPs are qualified plans, there are qualified plan rules a company must follow. A major difference between ESOP and other succession plans is the ESOP cannot pay more than fair market value for the company. As a trust, your ESOP would have a trustee that would negotiate each transaction and annual administration of benefits based on an independent appraisal.

ESOPs are a trust with potential tax benefits. Therefore, there are legal nuances to the plan design and administration. Partnering with an experienced and trusted ESOP partner will help companies navigate these challenges with ease and prepare your business for the future.



Why Should You Choose an ESOP?

ESOPs offer a variety of benefits for both the business owner and employees. Owners can actively participate in the succession of the company and may remain involved after selling the company. An owner selling to a third party or competitor would run the risk of potential immediate disinvolvement upon signing the purchase agreement, a harsh halt to employee engagement, communication, and public relations.

A well-designed ESOP permits owners to be involved in the company post-sale with a specially designed role. This freedom enables owners to retire on their own terms and help the company communicate the transition with key stakeholders.

Another benefit of an ESOP is it's a relatively private process. A third-party sale exposes your business to multiple buyers digging through your company's information. With an ESOP, you'll hire a trustee and negotiate transactions without disclosing sensitive information to multiple suitors, some of which may be major competitors.

ESOPs also come with many financial benefits. Selling shares in a privately held company to an ESOP allows a business owner to diversity their wealth and lower financial risk. Companies selecting an ESOP will also experience tax advantages, as payments to the ESOP to buy stock can be tax deductible. Additionally, owners selling shares of a C-corporation to an ESOP can defer capital gains on the sale proceeds when selling 30% or more of their ownership interest. As an S-Corporation, the company can avoid having to fund the payment of Federal income taxes post transaction, which creates additional cash flow to finance the purchase price.

When Should I Start the ESOP Process?

Owners considering retirement should begin the succession process several years before they ultimately want to be done. Establishing a healthy ESOP typically takes several years. However, beginning the ESOP process doesn't mean your time has to be up he end of the several year window. Owners have much more flexibility to stay on and transition to retirement, ultimately a key selling point for considering an ESOP.

Who are the Best Candidates for an ESOP?

To help figure out who is best suited for an ESOP, think of who you want to run your company after you retire. An ESOP allows you to pass your business on to the employees who have helped you build it. This means that all of your employees will be able to become beneficiaries of a trust that owns stock in the company and be even more invested in its success than before while you get to dictate the process. As they company increases in value, employee's retirement accounts will increase in value.

However, an ESOP is not for everyone. It's important that you have a strong management team to carry on your legacy and keep the business profitable. However, you'll have more freedom to groom the right team to succeed if you don't have to worry about third party buyers taking over and telling you what will happen.

There's also the matter of whether any children may succeed you. If you have a child, or multiple children, who plan on taking over after you retire, you would be better suited with other succession planning options. However, children are not always guaranteed to be either willing or suited for a leadership role. If this is the case, your children can still be part of the successor group with an ESOP and you can feel comfortable that your business is in the right hands.

A common question for business owners considering selling the company to an ESOP is regarding size. Unfortunately, there's no right answer or even a one-size-fits-all solution. While our ESOP experts may recommend employee size of at least 20 and annual revenues of at least $2M, ESOP solutions can be designed for smaller companies. Business owners should review transaction costs and annual expenses to managing the ESOP trust. Costs to manage the trust and conduct the annual required valuations and plan administration should be considered. Creating a successful ESOP requires a well-rounded team of experts – independent valuators, attorneys, and a trustee to name a few – and associated costs should be included in the calculations. Bottom line – ESOPs are different for all-sized companies and can be assessed by professional with experience to determine the best option.

Additionally, good candidates for an ESOP include companies with large enough employee headcount to allocate shares in a way that does not create a burdensome repurchase liability as employees leave the company.

Now that we've introduced the concept of an ESOP and good candidates, let's discuss key mechanics of how ESOPs work.

ESOP BASICS AND BENEFITS

An ESOP is a defined contribution plan, as stated by the IRS. Typically, classified as a qualified stock bonus plan, ESOPs were included as a qualified retirement plan in 1974 under IRS code 4975. The design of the ESOP plan by the IRS allows employees to attain a beneficial ownership in the business, while maintaining their hired role within the organization.

A majority of ESOPs are designed when an owner plans to retire from the company. Research supports the benefit of ESOPs impact not only the retiring owner, but also the employees.

An ESOP can be compared to a profit-sharing plan. A successful ESOP establishes a company trust fund, where shares of its stock or cash are contributed. The ESOP can also borrow funds to purchase new or existing shares.

Shares of the company stock are allocated to participating employees. With some exceptions, typically all full-time employees over the age of 21 are eligible to participate in the ESOP. Allocations of stock usually take place on the payroll schedule or a combination of payroll and years of service.

The employee account is subject to vesting. An employee must be 100% vested in the company's ESOP within three to six years, based on the selected vesting schedule (cliff or gradual).

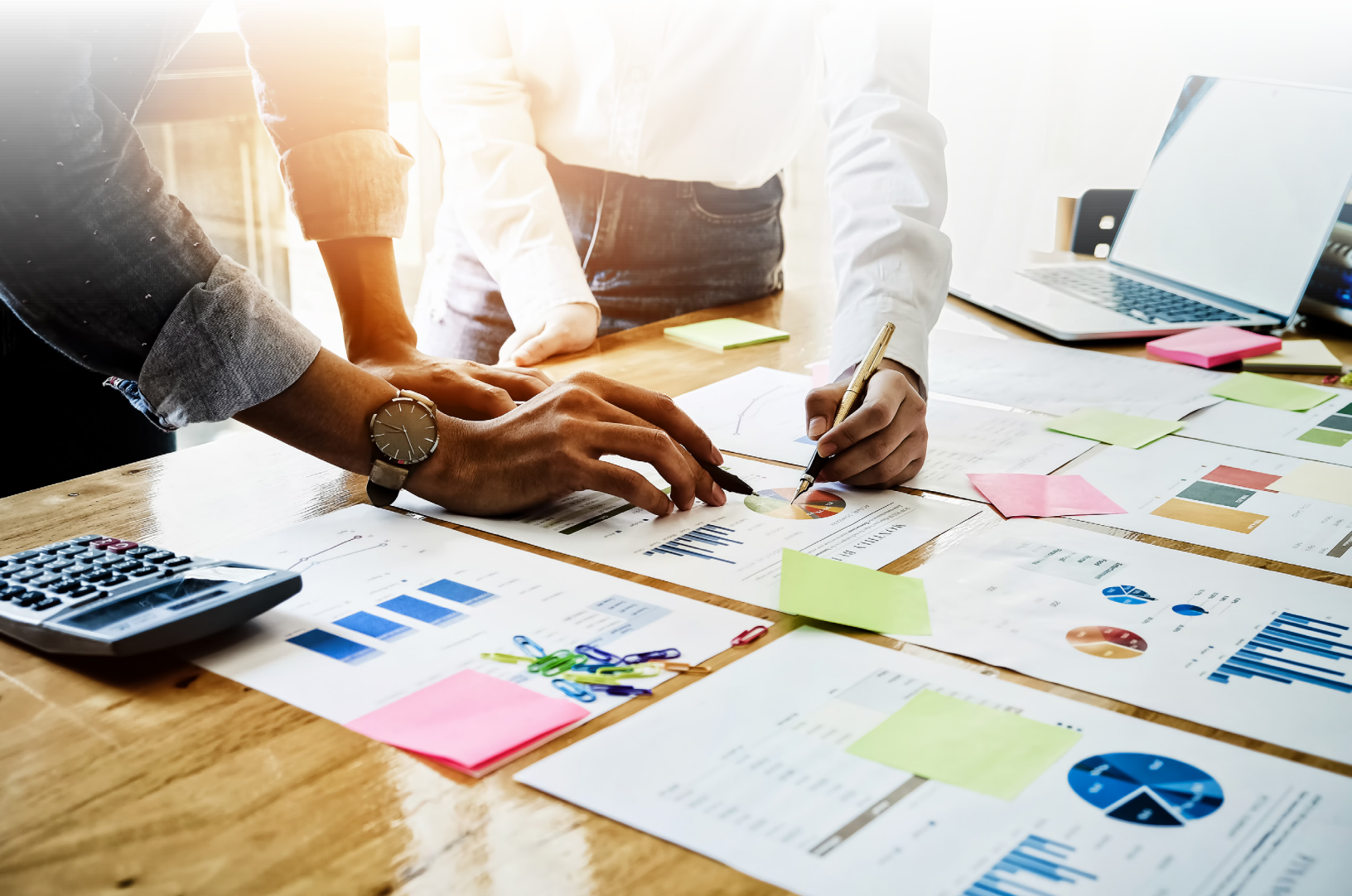
Employees are given the option to diversify out of employer stock once they obtain the age of 55 and have participated in the plan for 10 years. At this point, the employee can diversify up to 25% of the shares in their account balance for the next five years and at the age of 60 can increase their diversification to 50%. The diversified assets can be retained in the ESOP and invested in other assets, paid out to the employee, or transferred to the employer 401(k) plan.

If an employee leaves the company, the company must buy back their stock at fair market value. This requirement to repurchase shares from departing employees creates a repurchase obligation for the company. It is important to monitor the obligation and plan for it as you are planning out future cash needs of the business. The payment schedule can vary based on the plan document, but regulations dictate the maximum time for payout. Generally, in the event of retirement, disability or death, distributions start in the plan year following the time of the event. In other cases of termination, distributions are to start within the sixth plan year following the plan year of separation. If the ESOP loan is still outstanding, distributions do not need to start until the plan year after the ESOP loan is paid off.

HOW YOUR BUSINESS WILL BE VALUED

A key component in succession planning, regardless of the selected end game, is to have your business independently valued. Understanding your business's value is critical for a possible sale, merger, acquisition, estate planning, and preparing for an ESOP.

Experienced owners are often deeply rooted in the weeds of the day-to-day operations of their business, resulting in a possible distance of knowing true value. As much as proprietors would like to quantify their blood, sweat, and tears poured into a business, only an experienced, third-party valuation can provide accurate market insight. Industry colleagues and competitors may provide false commentary on what they "heard" a similar-type business is worth, when usually this number may be inflated, misrepresented, or flat out false. Partnering with a business advisor helps business owners measure an accurate pulse of their company's financial health to successfully prepare for an ESOP.



A simplistic approach to measuring your company's health includes:

- Cash flow: The starting point for cash flow is usually Earnings Before Interest, Taxes, Depreciation and Amortization (commonly known as EBITDA). Adjusting this earning stream for a potential buyer includes removing any special circumstances in place for the operation. For example, this could include excess owner compensation or perks, non-recurring and unusual items. This measure is typically adjusted for the above-mentioned items and plays a key role in valuation.
- Multiple: A multiple is applied to adjusted EBITDA or another cash flow measure to arrive at a value in certain business valuation methods. Depending on the cash flow stream used, certain adjustments may be needed to arrive at an equity value. How is a multiple selected? Typically, from public markets and/or private transactions of similar businesses and usually you will find a range of multiples in the industry. The appropriate multiple is selected by comparison of the company to a peer group for factors such as:
    - Growth – how fast is the business growing? Can it continue to grow in the future?
    - Sustainability – are revenue and cash flow recurring in nature?
    - Profitability – how profitable is the business? How does the profitability compare to the industry?
    - Customer concentration and attrition – does the business rely on one key customer? What is the customer attrition rate?
    - Management/key employees – do key individuals drive the business? Will the company not perform as well without them on staff?
    - Industry risk/regulation – if the industry is heavy regulated, how could this impact the business?
    - Technology risk – is complex technology required to run the business? Does the business have any intellectual property and if so, is it properly protected?
    - Balance sheet – are leverage and liquidity adequate?
- Knowing these key considerations when determining value helps develop a realistic expectation of what a potential third-party buyer could be expected to pay.

CONDUCTING AN ESOP FEASIBILITY STUDY

If you've decided to take a closer look at an Employee Stock Ownership Plan (ESOP) for your succession plan, you may be wondering what the next steps are. The typical next step is an ESOP feasibility study. This process is important in providing information to shareholders considering selling shares to an ESOP. The scope of a feasibility study can vary, but several key issues should be addressed and outlined. The study should provide the foundation for the company and selling shareholder to determine if an ESOP is the right choice or if other options should be explored.

Key issues that must be addressed in a feasibility analysis include:

- What is the size of the company?
  - Ideal ESOP candidates should have at least 20-25 employees and upwards of $2-$3 million in market value.
  - Eligible payroll needs to be large enough in order to remain within contribution annual limits to pay off the ESOP loan within are reasonable period of time.
- What are the seller's expectations for value?
  - Owners need to have realistic expectations of value during the process. The ESOP can pay no more than the fair market value of the interest it is acquiring. Just because someone at a trade show mentioned a competitor was sold for 2x revenue, doesn't mean that is an accurate indication of fair market value. A feasibility study should contain a preliminary valuation with an estimate of the fair market value of the interest being sold to the ESOP. That value must be in sync with the target or goals of the selling owner(s).
- How will the transaction be financed, and how will this impact the cash flow of the company going forward?
  - Do the sellers want cash up front, or are they willing to hold seller notes? Seller notes and corresponding warrants can be attractive to both the company and the seller, allowing for lower interest payments up front and potentially a higher return to the seller down the road.
  - The proposed ESOP transaction must cash flow. The ESOP is a financial buyer and, therefore, the company must be able to cash flow the proposed transaction. This is a key factor that must be determined.
  - Overly cyclical companies may not be ideal candidates for an ESOP. This is especially true for companies seeking a leveraged transaction, in which an established track record of profitability and cash flow are essential.
- Management team
  - Does the company have a team in place, or in training, to lead and manage the business going forward?
  - The seller needs to know who will write the checks going forward.

- What are the owner(s) goals and desires?
    - Typically, closely-held companies are the best ESOP candidates. If the company has multiple owners, it may be difficult to get everyone on board with an ESOP. Another aspect of a good candidate includes the owner(s) being concerned about legacy and rewarding employees for years of service.
    - Owners also need to consider if a sale to a strategic or financial buyer better meets their needs and desires.
    - How long does the owner want to remain with the company? Often, selling shareholders wish to stay with the company long after the ESOP is formed. How long and in what role the seller wants should be considered.
- Employee demographics
    - Understanding employee demographics is critical. The relative age of the workforce and employee turnover rates are important factors to consider.
    - What type of culture is in place at your company? The more engaged the culture, the easier the transition to an ESOP company. For more disengaged workforces, an ESOP structure can be a powerful tool to improve engagement. However, a considerable amount of education and training need to surround it.
- How many shares will be sold – 100% or some other interest?
    - Some companies go from 0% to 100% immediately, while others prefer step transactions in which pieces are sold to the ESOP over time. This factor will be decided based on facts and circumstances specific to each company.
    - If control is sold, how will management and the existing controlling shareholders react to a trustee having voting/control going forward?

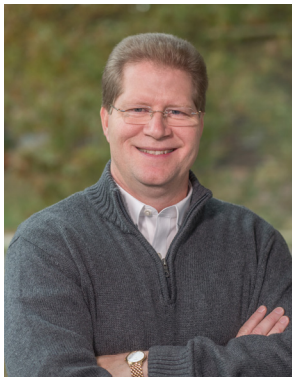
Key elements of the feasibility study include:

- A preliminary valuation of the company to determine what the ESOP could potentially pay for the shares.
- An analysis to determine how the potential transaction financing will impact shareholders and the company's financial performance in the future.
- Assessment of the management team.
- Evaluation of how the ESOP fits with the owner's goals.
- Plan design to determine the best structure and plan features for the ESOP.
- An analysis of future repurchase obligations and how that will impact the company going forward.

Consideration for Next Steps

Taking the steps to consider the next generation of your business can be both emotional and overwhelming. Researching all the options available to approach retirement will provide a full-circle view of opportunities. Discussing your company with our team of professionals can determine if an ESOP is a beneficial option based on your business's specifics. Our team has completed more than 2,000 valuation engagements and we work annually with approximately 60 ESOP companies.

If you're interested in selling your company to an ESOP, let's discuss your business and determine the benefits. Contact our team of experts today to take the first step – email ESOPS@applegrowth.com to get started.



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