ESOP
Questions & Answers

BRERETON, HANLEY & CO., INC.

Private Investment Banking
& ESOP Advisors

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The Great Recession of 2008 – A Game Changer

After Lehman Brothers was allowed to fail in September of 2008 the U.S. credit and capital markets changed—permanently. Whereas banks had been free to lend at excessive multiples prior to the federal government's bail out of and ownership in America's banks, the subsequent and increasing regulations placed on our banking sector creates new valuation realities for business owners.

The amount that an outside buyer of your business is willing, and able, to pay is almost exclusively a direct function of how much he or she can borrow against the assets and future cash-flow of your business (see diagram inset below). When banks were able to lend, on average, 5x cash-flow, buyers could pay 7x to 8x cash-flow for the company. If banks can or will only lend 3x cash-flow, buyers will only pay 4x to 5x for businesses.

Acquisition Multiple = Senior Lending Multiple / (1 – Equity Investment)

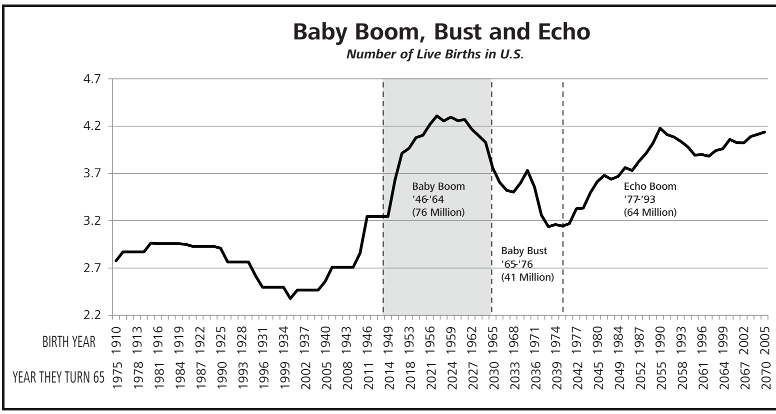
= 3 / (1 - .35)

= 4.6 x

Lenders now lend only approximately 3x, while investors and buyers are hard pressed to equity finance more than 35% of an acquisition as they seek the highest return on equity possible. This is the new reality. With our new understanding of proper, sustainable, regulated lending rates, the record high purchase price multiples of the last decade are gone forever.

We believe there are three important considerations when contemplating private company liquidity multiples from now through 2025.

First, the Baby Boomer Retirement Wave of the 76 million Americans who were born between the years 1946 and 1964 will see about three times the number of business owners sell their businesses over the next 15 years. The supply and demand imbalance caused by this unprecedented number of sellers flooding the private capital markets will keep purchase price multiples depressed during this period (see diagram below).

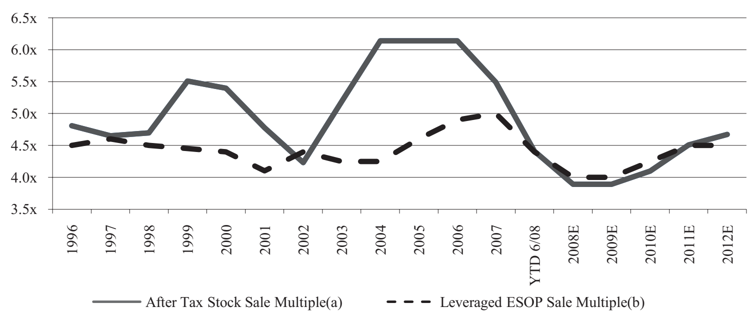


Second, we believe an upper limit on the amount of money a U.S. bank can lend to a particular company will be placed by federal bank regulators to ensure that the American tax payer never has to bail out U.S. banks again. The effect of this permanent change will be the effective "capping" of private company purchase price multiples on a go forward basis. This systemic change in credit availability when coupled with the supply imbalance caused by the Baby Boomer Retirement Wave supports our thesis that, under the best of circumstances, one can only expect to achieve an exit multiple of between 4x and 5x when "selling out" to an outside buyer during the next 15 years.

Finally, we believe that these next 15 years will be a period of rising tax rates in the U.S. as our government will need to fund the Social Security and Medicare dilemmas caused by the Baby Boomer Retirement Wave, to say nothing of paying for the War on Terror and deficit spending caused by the Great Credit Crisis and Recession of 2008.

Because, as you will see, the ESOP transaction is a tax-advantaged transaction, its economic appeal relative to “selling out” at 4x to 5x will remain greater and grow more attractive with every new tax hike. Today, one can achieve the same level of after-tax liquidity through an ESOP transaction as can be achieved through an M&A transaction, while gaining control and certainty of the transaction. It appears clear that, in terms of after tax liquidity, the ESOP transaction will be to the next 15 years what the M&A transaction was to the last 15 years.

Comparative Middle Market After-Tax Sale Proceeds as a Multiple of EBITDA



(a) Based on IMAP Middle Market EBIT index less an assumed 15% capital gains tax and 10% depreciation and amoritization discount..

(b) Total Leverage defined as Standard and Poor's historical Middle Market LBO average Senior Debt/EBITDA plus 1.0x.

Source: International Network of M&A Partners, Standard & Poors Inc. and Brereton, Hanley & Co. Inc.

Introduction & History of ESOPs

The ESOP transaction is one of the least understood transactions in the private capital markets. The goal of this booklet is to make a complex transaction easy to understand.

If given the choice, most owners of privately held businesses would like to liquefy some portion of the equity they have worked so hard to build in their companies. If this can be done without giving up control of the business, without changing the identity of the company and without imperiling the jobs of the loyal employees who helped to make the business what it is, so much the better. Money being equal, it is a rare business owner who would choose to "sell out" and lose control if they can realize comparable liquidity without giving up control. The money is now equal and should remain so for the next decade.

The ESOP transaction can provide the optimal solution for business owners seeking to do these things. In fact, the more you read and learn, the more amazed you will be with this powerful tool Congress gave us in 1974.

The earliest example of employee stock ownership can be traced back to the Sears Roebuck Company in 1916. In that year Sears Roebuck decided to fund its pension plan primarily with company stock. The Board of Directors' concept was that the employees' ownership of Sears' stock was a good retirement benefit for them and at the same time, an excellent way to motivate employees to improve the company's profitability and thus its value.

In the early 1970s many successful small to medium-sized companies were struggling with the challenges of succession when the business owner retired or died. After a lifetime of work, owners and employees would have to either liquidate the company or sell it to an outsider.

To promote employee ownership, very substantial ESOP tax advantages were created by Congress in 1974 when it enacted the Employee Retirement Income Security Act of 1974 (ERISA). ERISA established the rules and guidelines for establishing and administering employee benefit plans, which an ESOP technically is. The federal government's commitment to ESOPs and their incentives for business owners and employees have remained unwavering since 1974. As of this writing, there are actually new bills before Congress seeking to enhance and increase the use of ESOPs.

The two most common questions people ask as they learn more about how the ESOP transaction can address their needs are: (i) why aren't there more of these? and, (ii) what is the downside of these transactions?

The answers to these questions are fairly simple. First, most ESOP professionals agree that the two reasons there aren't more ESOP-owned companies is because: a) most people — CPAs and attorneys included — don't take the time to learn about this structure and dismiss it as "something too complicated to do." And, frankly: b) the average purchase price multiple one, historically, could realize by selling out to a third party has been higher than the ESOP alternative. Despite its current superiority, the ESOP continues to be a victim of widely held misconceptions. As you will see, however, we believe the ESOP alternative will remain more economically attractive than selling out for the next fifteen years.

As for the answer to "What is the downside of doing an ESOP?" see Chapter 8 (The Disadvantages of ESOPs). Having advised on dozens of M&A tranactions since 1995, we maintain that the disadvantages of ESOPs are no greater than the legal disadvantages of selling out and it's complexity no more than that of selling all or part of your company to a private equity group.

Features and Benefits

With an ESOP, the owner of a privately-held company can:

- Sell stock of the company, pay no tax on the proceeds and still keep control
- Increase the company's working capital and cash flow with no cash expenditure and no productive effort
- Buy out minority or majority stockholders with pretax dollars
- Make acquisitions with pretax dollars that are tax free to the seller
- Cut the cost of borrowing loan principal nearly in half by deducting principal payments as well as interest
- Provide employees with equity upside with no cash outlay on their part or the owner's part.

There are over 11,000 ESOP owned companies in the United States including the likes of: General Mills, Mens' Warehouse, Paychex, Round Table Pizza, Davey Tree, Graybar and many more.

All of the parties to the transaction can benefit from the establishment of an ESOP:

The Business Owner(s) as Seller(s)

In certain sales to ESOPs the seller(s) may be eligible to defer the capital gains tax otherwise due from the sale. To qualify for this tax deferral, the ESOP must own no less than 30 percent of a privately held company's stock and the seller(s) must satisfy certain other requirements. Namely, the individual seller (not to be confused with the company itself) cannot be a "C" corporation. The sale must otherwise qualify for long-term capital gains treatment. The seller(s) must own the shares for at least three years and the sale proceeds must be reinvested into qualified investments, such as U.S. company stocks and bonds. Through this benefit, a 1042 Rollover, per the Internal Revenue Code of 1986 (Code), allows business owners to create and enjoy tax-free liquidity when certain steps are followed.

The Company as Sponsor

Companies can make annual tax-deductible contributions to ESOPs, resulting in a tax shield that creates financial value (discussed in detail in the section entitled *Economics of an ESOP*). The tax-deductible ESOP contributions enable the ESOP to make principal payments on the debt it incurred to purchase the stock in the company. This use of pretax dollars to repay indebtedness significantly enhances the value of the ESOP tax shield. Furthermore, contributions to pay interest on ESOP debt are generally tax-deductible, as are cash dividends paid on ESOP stock if such dividends are used to repay debt.

The Employees as Buyers

Employees do not have to have the money necessary to buy the stock nor do employees have the right to vote or exert control over the daily operations of the business as is a popular misconception. Further, employees have no say in the adoption of an ESOP. Employees who purchase all or part of "their" company through an ESOP have a unique opportunity to build wealth via underlying stock appreciation without personal liability. In addition, employees, through the ESOP, have some control over their financial destiny. Finally, the employees are not taxed on their benefits through the ESOP until they receive them.

The Financial Institution as Lender to the ESOP

Often ESOPs use a loan from a financial institution to purchase company stock. Lenders who understand ESOP rules are more motivated to lend into an ESOP situation compared to making non-ESOP loans. Borrowing through an ESOP actually improves a company's cash flow versus non-ESOP borrowing due to the aforementioned tax shield. Also, ESOP loans provide the lender with a larger collateral pool compared to traditional acquisition financing. It is for these two reasons that banks still aggressively lend into ESOP transactions, even during periods of tight credit.

The Productivity Benefit

A 2008 study funded by the ESOP Association found of the 328 ESOP-owned companies and over 2,000 matching non-ESOP-owned companies studied that majority employee-owned businesses have a significant sales-per-employee advantage over their non-ESOP counterparts in the same industry and of the same size. The average advantage—$44,500—means that a typical 200 person ESOP-owned company could be expected to have an almost $9 million annual sales advantage over its non-ESOP counterpart. This is the latest one of many studies conducted over the past 20 years that have shown employees at ESOP-owned companies to be more productive than employees at non-ESOP-owned companies.

ESOP-owned companies also enjoy a significantly lower loan default rate than do private equity group acquired companies. According to the *Wall Street Journal* the default rate for ESOP loans have historically clocked in at less than one half of one percent. By contrast, private equity-owned companies have historically logged a 19.4 percent default rate.

Perspective of the Selling Shareholders

Shareholders of privately held companies often face dilemmas:

- They have no liquidity for their business investment.
- A substantial portion, if not all, of their net worth is tied up in the business.
- There are few, if any, potential investors who are willing to acquire minority interests in private companies.
- They have missed the window of opportunity to sell out at a premium.
- There are limited options to business succession.

Consequently, business owners often have only one liquidity option: *sell the company* at what the market will bear, which is unattractive. The ESOP provides a unique alternative to selling shareholders.

How does an ESOP create a shareholder liquidity alternative?

The ESOP creates a "friendly" buyer for the stock. Furthermore, an ESOP is designed to enable a business owner to achieve his objectives:

The seller may sell stock to an ESOP and still be able to run the company. (The ESOP, however, must be operated under ERISA guidelines as discussed later.)

The seller may sell stock to an ESOP over time when it is convenient (rather than all at once as a traditional purchaser would require).

What is a Section 1042 Transaction?

If an ESOP purchases at least 30 percent of the outstanding stock of a privately held company and the selling shareholder(s): (1) are not "C" corporations, (2) have owned their stock for at least three years, and (3) are otherwise eligible for capital gains treatment, the selling shareholder(s) can defer virtually indefinitely the taxes on their gain. To obtain this tax benefit, the selling shareholder(s) must reinvest the proceeds in "qualified replacement property" within a period beginning three months prior to the sale and ending 12 months after the sale. Such a Section 1042 transaction, which derives its name from the section of the Code which governs its availability, is often referred to as a "1042 Rollover" or "Tax Free Rollover."

What is Qualified Replacement Property?

In general, qualified replacement property (QRP) includes stocks and bonds of U.S. corporations, both public and private. QRP includes, for example, common stock, preferred stock, corporate notes and bonds, convertible bonds and floating rate notes. As of this writing, QRP does not include U.S. government municipal securities, foreign securities, mutual funds, limited partnerships or the stock of the corporation (or its affiliates) that is the subject of the ESOP transaction.

In addition, brokerage and investment firms offer products that essentially allow the seller to borrow against his QRP to provide further personal liquidity. In doing so, one may legally invest in the aforementioned securities not included on the QRP list or use the cash as they choose.

How significant is a tax deferral to a selling shareholder?

Extremely significant. Sellers should always analyze any proposed transaction alternatives on an after-tax proceeds basis. Although selling a portion of a business to an ESOP may result in a lower selling price than selling to a strategic buyer, the indefinite deferral of capital gains taxes for the selling shareholder usually far outweighs any price difference.

If I sell a portion of my company to an ESOP today, will that make my company less attractive to investors or buyers at a later date?

No. Because the ESOP acts as a single, integrated entity, it should be viewed as simply another shareholder whose acts are controlled by a sophisticated investor (the trustee) which can be a trust department of a bank or trust company. About 90% of all ESOPs are trusteed by the seller, however, which is perfectly legal.

Which shareholders can take advantage of a 1042 Rollover?

Individuals, trusts, partnerships, estates and charitable entities may elect the 1042 Rollover.

Is an ESOP compatible with my 401(k)?

A 401(k) plan is fully compatible with an ESOP since 401(k) plans and ESOPs are both defined contribution plans. Most ESOP-owned companies also have 401(k)s though not out of necessity.

If the company has a separate 401(k) plan, we recommend that the plan be continued as a separate plan. However, the company may want to consider having future matching contributions go to the ESOP rather than the 401(k) plan due to the inherent tax benefits.

Mechanics of an ESOP Sale

Technically, ESOPs are tax-qualified, defined contribution plans that are stock bonus plans or a combination of a stock bonus plan and money purchase plan designed to invest primarily in the employer securities. As you will see, an ESOP is also a Congress-sanctioned corporate finance tool.

What is a tax-qualified employee benefit plan?

A tax-qualified employee benefit plan is a retirement plan that meets special rules for tax qualification under Section 401(a) of the Code. Employer contributions to tax-qualified plans are tax-deductible within certain limits. A 401(k) is one example of such a plan as is an ESOP.

What is a defined contribution plan?

In the broad category of tax-qualified employee benefit plans; there are two general categories of plans: *defined benefit plans* and *defined contribution plans*. Defined benefit plans provide a fixed schedule of benefits for an employee upon retirement with varying, but mandatory, annual company contributions. ESOPs, by contrast, are defined contribution plans to which the company makes annual contributions which may vary year to year. The income an employee receives from an ESOP upon retirement is a function of the contributions made to the plan and the performance of plan investments, rather than a pre-determined benefit based on a fixed formula.

How does an ESOP differ from other types of defined contribution plans?

In general, while defined contribution plans may invest all or a portion of their assets in employer stock, ERISA suggests that defined contribution plans (other than eligible individual account plans) invest in a diversified portfolio of securities. However, ESOPs are designed to invest primarily or exclusively in the stock of the sponsoring company and may borrow money to make these investments.

How does the leveraged ESOP transaction work?

Leveraged ESOPs are distinct from other types of employee benefit plans. A leveraged ESOP borrows money from the company, the selling shareholder(s) or third-party lender (hence "leveraged") using a guarantee or other extension of credit and purchases either: (1) existing stock or (2) newly issued stock. Leveraged ESOPs are economically attractive for the following reasons:

- Contributions by the company to pay both interest and principal payments on ESOP debt are tax-deductible within certain limits. Thus, annual tax-deductible ESOP contributions are used to repay the principal on the outstanding ESOP indebtedness to the lender.

- Loans for a leveraged ESOP transaction are more readily made due to the stronger cash flows of the ESOP-owned company because of the tax shield afforded under the law.

- Cash dividends on ESOP stock used to repay ESOP debt may be tax-deductible

Consequently, leveraged ESOPs can actually create value by virtue of the tax shield created. The leveraged ESOP can purchase existing stock or newly issued stock, which is a very unique corporate finance tool.

Purchase Existing Stock

Figure 1 below illustrates how an ESOP borrows money from a third-party lender and then purchases existing stock from shareholders. This type of ESOP can *create shareholder liquidity*.

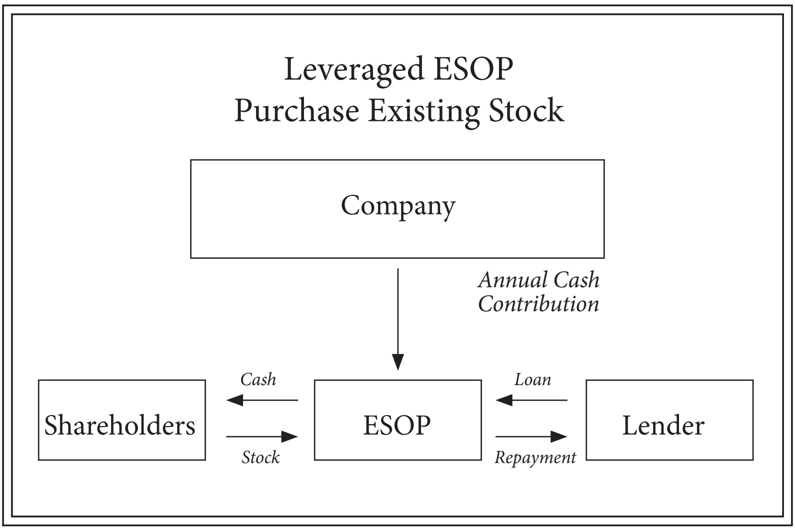


Figure 1

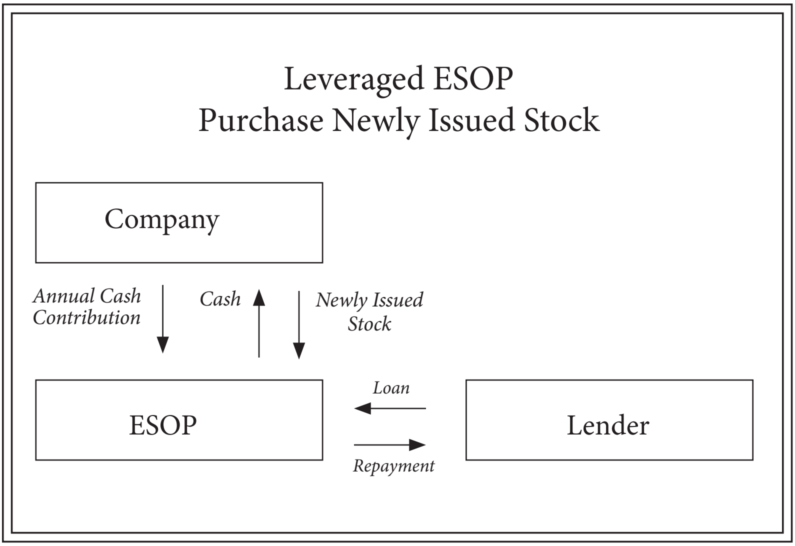


Figure 2

Purchase Newly Issued Stock

Figure 2 above illustrates that the ESOP borrows money to purchase newly issued stock from the company. This form of ESOP can be used as a corporate finance tool to raise tax-advantaged capital. As the ESOP loan is repaid it "turns into equity," as discussed in the section entitled *Economics of an ESOP* beginning on page 21.

Leveraged ESOPs may hold only voting common stock or preferred stock convertible at any time into voting common stock of the company. If the company (or any related company) has publicly traded common stock, the ESOP must purchase that class of common stock or preferred stock convertible into such common stock.

What is meant by "covered payroll?"

In general, a company can contribute up to 25 percent of covered payroll to a leveraged ESOP. In certain cases, the company can contribute up to 25 percent to the ESOP just to repay principal on the ESOP's debt; in addition, interest expense on the ESOP's debt is tax-deductible. ERISA provides that the contribution to each individual participant cannot exceed the lesser of $46,000 or 25 percent of the employee's annual compensation. In effect, this rule creates a contribution cap for individuals earning over $184,000 annually. Other contribution rules may apply.

How is stock allocated to an employee's account?

In general, stock allocations for both non-leveraged and leveraged ESOPs are based on a formula using individual participant's relative compensation.

Can ESOPs contain vesting provisions?

Yes. An ESOP must, however, comply with one of two minimum vesting schedules under ERISA: (1) 100 percent vesting after three years of employment or (2) 20 percent vesting per year beginning in year two and continuing through year six.

Do employees vote their stock in the ESOP?

Employees have the right to vote only on certain major corporate issues such as the sale of the assets of the company, liquidation, etc. On all other matters, and with respect to shares not yet allocated to participants' ESOP accounts, the ESOP trustee or fiduciary, typically the seller, exercises voting rights, following the fiduciary guidelines under ERISA.

While ESOPs are, by their very nature, essentially undiversified benefit plans, are there any diversification options or requirements?

Yes. Employees who have attained the age of 55 and have participated in the ESOP at least ten years may elect each year, over a subsequent six-year period, to diversify up to 25 percent of their ESOP holdings. In the last year of this period, qualifying employees have an opportunity to diversify up to 50 percent of their holdings, reduced by amounts previously diversified.

How do employees sell the stock they receive from the ESOP?

ESOPs in privately held companies provide a “put option” to the employees who receive employer stock (rather than cash) from the ESOP. In general, departing employees have the right to “put” their stock back to the company (or the ESOP) at fair market value (discussed later). Payments are made in a lump sum or on an installment method. If the installment method is used, a market rate of interest must be paid on the outstanding balance, adequate security must be provided, and payments must be made over a period not to exceed five years.

Distributions from ESOPs in publicly traded companies are not subject to this “put option” requirement because employees can sell their stock in the open market.

Does the ESOP participant’s “put option” create a repurchase obligation for the company?

Yes. However, the perceived burden of the repurchase obligation should not be overstated. Proper corporate planning can easily address this obligation. Many strategies exist, including funding the repurchase obligation with cash contributions to the ESOP or cash accumulations at the company level, purchasing insurance, re-leveraging the company, or a public offering.

Economics of an ESOP Transaction

How do ESOPs create value?

Aside from potential productivity improvements, ESOPs provide economic benefits by essentially creating a tax shield on the earnings of the company, as previously discussed.

Leveraged ESOPs borrow funds to purchase stock using a guarantee or other extension of credit from the company or the selling shareholder(s). The ESOP indebtedness is repaid via annual company contributions to the ESOP. The figure (3) on the next page illustrates the creation of value through the use of a leveraged ESOP.

Economic Benefits of a Leveraged ESOP
(Increasing Cash Flow)

Assume:

- Fair market value of company pre-transaction = $100 million
- Post-transaction, company is in a tax-paying position
- Company borrows $70 million
- Annual ESOP contribution of $10 million
- Corporate tax rate of 40%
- 20% discount rate for present value calculations

(In millions)

Year	Tax Savings on ESOP Contribution	Present Value at 20%
1	$4.0	
2	4.0	
3	4.0	
4	4.0	
5	4.0	
6	4.0	
7	4.0	
Total	$28.0	$14.4

Pre-transaction value*	$100.0	
Less: Debt	70.0	
Total equity value	30.0	
Plus: Present value of ESOP-related benefits	14.4	*(value created)*
Post-transaction equity value	$44.4	

* Value of total invested capital (i.e., value of company on a debt-free basis).

Figure 3

Valuation Issues

What is my business worth?

A business may have substantial value to its owner. However, an outside investor will assess the value of a business based on his expectations of future returns and the associated risk of eventually realizing those returns. The negotiated price usually results in what is known as fair market value.

What is fair market value?

Fair market value is generally defined as the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such an asset. The listed price of a security traded on an active exchange (like the New York Stock Exchange) is generally regarded as fair market value.

Wherever a "generally recognized market" is nonexistent for a company's securities, the Department of Labor ("DOL") defines adequate consideration as fair market value as determined in good faith by the appropriate plan fiduciary. The "good faith" requirement typically requires the fiduciary to obtain an independent appraisal from a qualified financial advisor.

Fair market value is always stated as of a specific point in time. Fair market value may change from day to day, as it does with publicly traded stocks.

What price can an ESOP pay for stock?

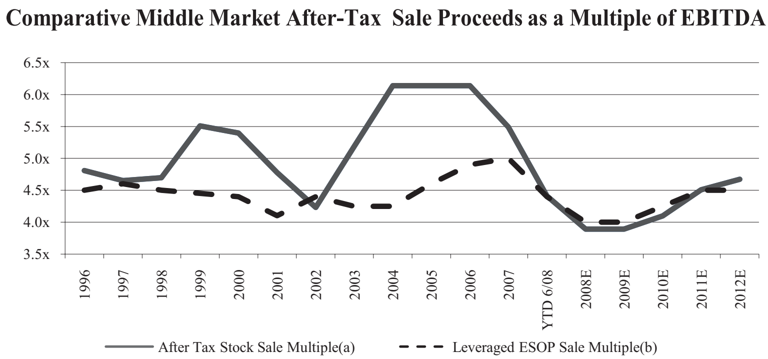
ERISA stipulates that an ESOP must not pay more than adequate consideration for the security. Closely held stock, in general, requires an independent appraisal by a qualified financial advisor.

What factors does an independent appraiser consider when appraising closely held stock?

In 1988, the DOL proposed regulations regarding the types of considerations and factors fiduciaries and appraisers should consider with respect to ESOP transactions (Guidelines). With respect to appraisers, the Guidelines outline the considerations and factors that should be considered in a valuation analysis and documented in a written report. In general, the Guidelines parallel Revenue Ruling 59-60, used for estate and gift tax valuations by the IRS, and require consideration of at least the following factors:

- the nature of the business and the history of the enterprise from its inception;
- the economic outlook in general and the condition and outlook of the specific industry in particular;
- the book value of the securities and the financial condition of the company;
- the earning capacity of the company;
- the dividend-paying capacity of the company;
- whether the enterprise has goodwill or other intangible value;
- the market price of securities of corporations engaged in a similar line of business, which are actively traded in a free and open market either on an exchange or over-the-counter;
- the marketability of the securities, or lack thereof, including whether the securities are subject to "put rights," as well as an assessment of the company's ability to meet its obligations with respect to the "put;" and
- whether the seller would be able to obtain a control premium from an unrelated third-party with regard to the block of securities being valued.

How does a Fair Market Value Opinion compare with the price I can sell my business for to an outside buyer?



(a) Based on IMAP Middle Market EBIT index less an assumed 15% capital gains tax and 10% depreciation and amoritization discount..

(b) Total Leverage defined as Standard and Poor's historical Middle Market LBO average Senior Debt/EBITDA plus 1.0x.

Source: International Network of M&A Partners, Standard & Poors Inc. and Brereton, Hanley & Co. Inc.

Figure 4

The average price a strategic buyer will pay for a privately-held company is almost always a function of how much debt can be borrowed to buy the company at the time of the acquisition. When banks lend aggressively, as they did from 2002-2007, as you can see in the above graph, sellers can achieve historically high after-tax purchase price multiples (solid line). The solid line tracks what the average seller could have achieved as an after-tax purchase price multiple.

Given the Credit Crunch and Great Recession which began in 2008 and the likelihood that the Federal government will not allow banks to experience the same leverage levels as they did prior to the meltdown and subsequent de-leveraging of the U.S. Financial Sector, it is prudent to assume for planning purposes that the ESOP transaction multiple will yield the seller more after-tax dollars (dotted line), on average, than one can realize by selling the company in the open market.

How does a financial advisor determine fair market value?

Given the facts and circumstances as of a particular date, a financial advisor attempts to determine the price at which a security would trade if a company's stock were publicly traded on an active exchange. In general, a financial advisor utilizes recognized valuation methodologies employed by investment bankers and business appraisers. These include:

- CAPITALIZATION APPROACHES
- DISCOUNTED CASH FLOW APPROACH
- COMPARABLE SALES
- INDUSTRY RULES-OF-THUMB
- ASSET APPROACHES

Conceptually, capitalization of earnings or cash flow is a simple two-variable approach, consisting of a figure for the company's earnings or cash flow and a figure for the appropriate price-to-earnings or price-to-cash flow ratio. The price-to-earnings or price-to-cash flow ratio is as straightforward as its name sounds – the price of the stock divided by the earnings or cash flow of the company.

- Representative earnings or cash flow are, in general, that which a business can be expected to generate as of the valuation date.

- Appropriate capitalization rates (or multiples) are generally based on how the market prices securities for comparable companies. Capitalization rates are derived by dividing the appropriate stock prices of comparable public companies by their relevant earnings or cash flows. Selected comparable public company multiples are adjusted to reflect comparisons of the subject company relative to the size, profitability, leverage, liquidity, operating characteristics and other factors of the selected comparable public companies. An example of market capitalization rates appears in the next Figure.

Example of Market Capitalization Rates

Athletic Shoe Industry

Price to Net Income

	Next Fiscal Year[1]	Latest Available 12 Months
Brown Group Inc.	15.2	18.5
L.A. Gear Inc.	285.4*	-4.0*
Nike inc.	11.4	11.6
Reebok International Ltd.	11.3	15.0
Stride Rite Corp.	12.0	14.3
Wolverine World Wide	16.1	20.8
Range: Low	11.3	11.6
High	16.1	20.8
Median:	12.0	15.0

[1] Based on publicly available earnings forecasts
* Not representative; excluded from range

Figure 5

Discounted Cash Flow Approach

The discounted cash flow (DCF) approach relies on the premise that a dollar received tomorrow is not as valuable as a dollar received today due to the time value of money. This is known as *the present value concept.*

In general, the DCF approach implies that the value of a company today is equal to the present value of the risk-adjusted expected future returns of the company, as illustrated in Figure 6 on the next page. The DCF approach requires three components;

- cash flow projections, supportable in light of recent performance;
- determination of an appropriate discount rate to reflect the perceived investment risk; and
- determination of "terminal value," the value of the company at the end of the project period.

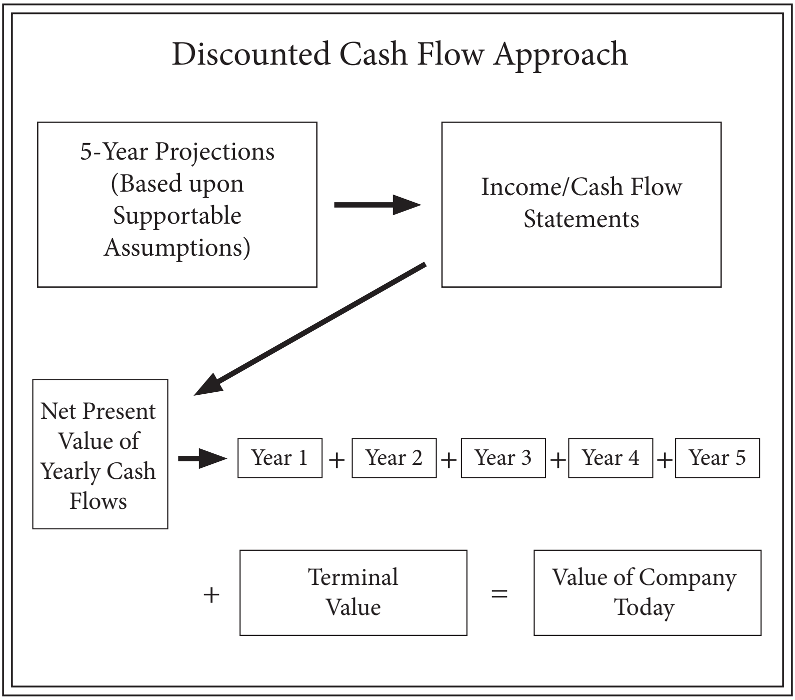


Figure 6

Comparable Sales

An analogy can be made to selling a house. If one were to sell a house, one would look to the surrounding neighborhood to examine the prices at which comparable houses have been sold. In comparing sales prices, the homeowner would make "adjustments" for the differences in the features of his house to the comparable houses. For example, all other things being equal, the homeowner would likely place a higher value on his home than the comparable homes if his home were larger or if it had a swimming pool.

With a company, an investor would assess comparable sales within an *industry*. The investor would first determine whether the transaction was conducted at arm's-length, thus representing an accurate reflection of fair market value. Next, the investor would analyze the consideration exchanged, including non-compete agreements and seller financing, among others.

Industry Rules-of-Thumb

Industry rules-of-thumb are a static indication of value and, accordingly, are seldom valid. Investors' sentiments are ever-changing, making valuation dynamic in nature. However, rules-of-thumb may be viable in industries whose cost structures are easily replicated (e.g., service companies) or where a company is comprised of financial assets and liabilities, such as financial institutions.

Asset Approaches

In general, there are two types of asset approaches. Going-concern asset approaches express value as a function of the company's book value or net assets. These approaches are useful for businesses with substantial tangible assets where recent earnings do not reflect the company's intrinsic value. Liquidation approaches are used when the company is better off "dead than alive," but are not typically used for ESOP valuations.

Financing and Accounting for ESOPs

How does an ESOP borrow money from a lender for a leveraged ESOP?

- The Mirror Loan

Lenders are often reluctant to lend to a "shell" entity, such as an ESOP trust. Rather, lenders prefer to lend to the primary source of repayment, the company. Consequently, as illustrated in Figure 7 below, the typical transaction calls for a lender to lend directly to the company, with the company, in turn, lending to the ESOP under substantially similar terms and conditions. This is known as a mirror loan structure. Mechanically, the company makes

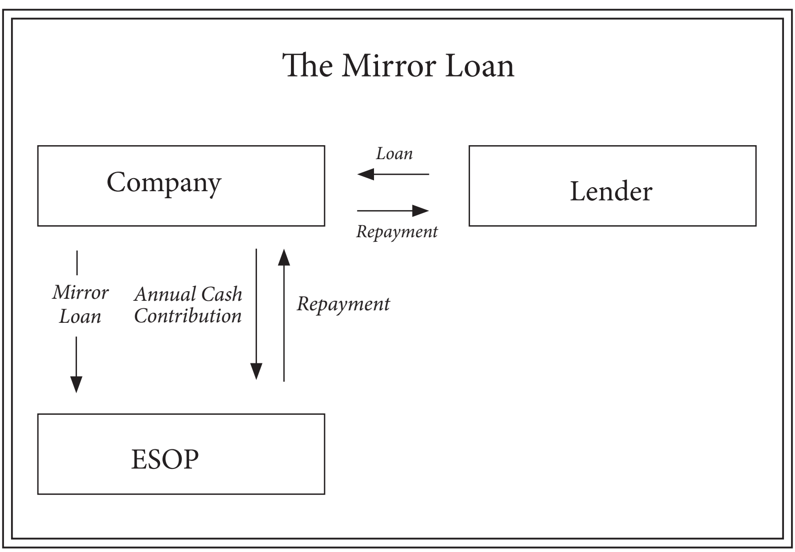


Figure 7

annual tax-deductible contributions (and/or pays tax-deductible cash dividends) to the ESOP, which then flow back to the company by virtue of the repayment of the mirror loan. The company then makes direct repayment to the lender.

Are lenders motivated to make ESOP loans?

Yes for two reasons:

- First, the tax advantages of a company borrowing through an ESOP (via the pretax principal repayment) actually enhances a company's cash flow compared to borrowing directly by the company. Enhanced cash flow is a critical component of credit quality and is attractive to lenders.
- Second, the stock previously owned by the business owner, now held by the ESOP, is almost always pledged as an additional form of collateral. This additional collateral support can make the difference between achieving liquidity or not achieving liquidity in a tight credit environment.

How is the ESOP debt accounted for?

Regardless of the form of the ESOP loan, the American Institute of Certified Public Accountants (AICPA) requires that the ESOP debt be reflected as a liability on a company's balance sheet, with the offsetting entry reflected as a contra-equity account, as illustrated in Figure 8 (without ESOP debt) on the next page and Figure 9 (with ESOP debt) which is under it. Certain other rules are promulgated, including: dividends paid on unallocated ESOP shares are treated as a compensation expense; the fair market value of stock allocated to employees is treated as a compensation expense; and so on.

Note: The accounting treatment for a leveraged ESOP may result in a company reporting a negative book value. While sophisticated lenders and investors recognize and distinguish between economic value and book value, some creditors, regulators, and other parties may lack the experience to assess such situations. Consequently, a company and its financial advisor are encouraged to address the implications of the ESOP debt accounting treatment at the onset of the transaction.

Accounting Treatment of ESOP Debt*

Pre-Leveraged ESOP

(Without ESOP Debt)

($ Millions)

Assets		Liabilities	
Assets	$10	Liabilities	$ 2
		Stockholders' Equity	8
Total Assets	$10	Total Liabilities and Stockholders' Equity	$10

** Per AICPA Statement of Position 93-6*

Figure 8

Accounting Treatment of ESOP Debt*

Post-Leveraged ESOP

(Assume $5 million ESOP Loan)

($ Millions)

Assets		Liabilities	
Assets	$10	Liabilities	$ 2
		ESOP Debt	5
		Total Liabilities	7
		Stockholders' Equity	
		ESOP Debt	(5)
		Retained Earnings and Paid-in-Capital	8
		Total Stockholders' Equity	3
Total Assets	$10	Total Liabilities and Stockholders' Equity	$10

** Per AICPA Statement of Position 93-6*

Figure 9

Is my existing lending relationship a potential source for ESOP financing?

Perhaps. ESOPs, in general, often require a cash flow-based lender. Furthermore, the economic and legal nuances of ESOPs often require a lender experienced in ESOP lending.

What are the sources of ESOP financing?

Sources of ESOP financing include national and regional banks, sub-debt funds, insurance companies, credit and finance companies and private investors. Your ESOP investment banker has knowledge of ESOP lending sources and can identify lending criteria.

What criteria do lenders evaluate when considering financing an ESOP transaction?

ESOPs must compete with other transactions on the basis of credit quality. The components of creditworthiness are numerous, and are summarized below:

- Protection of Principal

Lenders assess the risk of ultimate repayment by analyzing the values of underlying corporate assets that may provide for collateralization, subordination of other liabilities and, where applicable or necessary, other sources of repayment, such as third-party guarantees.

- Predictability and Stability of Cash Flow

Lenders assess the ability to service debt obligations based on the predictability and stability of a company's cash flow. In general, this is a function of historical performance and the overall health of a company's industry.

- Experience and Continuity of Management

ESOP loans are, in general, made on a *secured* basis. Consequently, lenders assess the company's ability to repay the loan based on expected future cash flows from operations. This requires that lenders assess depth of management and management's ability, based on management's experience and track record, to operate the company efficiently and profitably. Changes in management that may affect the company's future profitability, as a result of the transaction, will be considered (refer to the section entitled Preparing Your Company for an ESOP).

- Equity (Investment) Supporting the Financing

Much like buying a house, lenders require buyers to put equity into any transaction to protect the lenders' loan. Lenders require "meaningful" equity in today's ESOP transactions and prefer that management be investors with some of their own capital at risk (with a commensurate potential return). The company's financial advisor can assist in identifying creative ways to generate or provide for the requisite equity necessary to structure an ESOP transaction.

What is the financial advisor's role in obtaining financing?

- Structuring a Deal That Works

The success of a financial advisor or investment banker depends on "knowing the markets," (i.e., knowing what criteria various lending sources require given current market conditions and who the "players" are in a given market). Consequently, a financial advisor's role is to structure an ESOP transaction that is: (1) attractive to *lenders (see section entitled Role of Investment Bankers/Financial Advisors)* and (2) acceptable to the regulatory bodies that govern ESOPs (e.g., the DOL, FINRA, the SEC and IRS).

Disadvantages of ESOPs

The principal disadvantages and possible problem areas that should be evaluated in considering an ESOP are as follows:

- **Dilution.** If the ESOP is used to finance the company's growth as was described in Chapter 4, Section "Purchasing Newly Issued Shares," the cash flow benefits must be weighed against the rate of dilution caused from issuing new shares.

- **Availability of Financing.** One potential disadvantage of a sale to an ESOP versus a sale to a third party is that a sale to an ESOP depends upon the ability of the company to obtain the necessary financing. If the transaction is financed with a bank loan, the company must have the ability to obtain the necessary bank loan, based upon having sufficient cash flow to service the loan and sufficient assets to collateralize the loan. If the company does not have sufficient collateral, the seller may have to give a personal guaranty or may have to pledge a portion of the qualified replacement securities. On the other hand, a seller can always self-finance the sale in whole or in part if sufficient bank financing is not available.

- **Balance Sheet Impact.** If the company borrows money and lends this money to the ESOP to enable the ESOP to make a leveraged purchase of company stock, the accounting regulations require that the bank loan be recorded as a liability, and that a like amount be debited to a contra equity account. The net effect is to reduce the company's net worth by the amount of the bank debt. In most cases, the reduction should have little or no impact on the company's operations. If, however, the company is involved in the construction industry, the reduction in the company's net worth may affect the company's ability to obtain construction bonding.

- **Disclosure.** Participants receive an annual benefit statement from the plan, similar to the statements they receive from a profit sharing or 401(k) plan, showing the value of the company's stock held by the trust. Since they are not direct shareholders, they are not entitled to receive company financial statements or attend shareholder meetings.

- **Valuation.** The stock must be valued annually in order to establish the value of the stock for purposes of purchasing the stock, and distributing the stock. If the valuation is prepared by a qualified third party, the valuation should be immune from subsequent adjustment. If, however, the stock is overvalued, the consequence depends upon whether the stock was contributed or purchased.

  If the stock was contributed by the company at an excessive valuation price, the penalty would be a reduction of the deduction that the company had taken for the contribution. If the stock was purchased by the ESOP, the deduction would not be affected, but the seller would be required to pay back the excess purchase price. In addition, under ERISA, the seller is subjected to a 15% penalty tax for each year that the stock was overvalued.

- **Liquidity.** If the value of the stock appreciates substantially, the ESOP and/or the company may not have sufficient funds to repurchase stock upon employees' retirement. In most cases, very little liquidity will be needed in the first five years of the plan, since most employees who terminate in the early years are only partially vested. After the first five years, the ESOP should keep a portion of the fund in liquid investments in order to provide liquidity for retiring or terminating employees. Companies whose stock appreciates substantially typically are able to refinance the debt in an amount sufficient to accommodate the repurchase obligation, however.

- **Fiduciary Liability.** The plan committee members who administer the plan are deemed to be fiduciaries and can be held liable if they knowingly participate in improper transactions.

In general, the fiduciary liability under an ESOP is less than the fiduciary liability under a profit sharing plan, since the ESOP is primarily invested in employer stock. Under a profit sharing plan, the fiduciary has a wide range of choice of investments. The fiduciary must, therefore, diversify the investments, and all investments must meet the fair rate of return requirement. An ESOP, on the other hand, is exempt from the diversification and fair rate of return requirements, since the ESOP is designed to invest in employer stock.

- **Stock Performance.** If the value of the company does not increase, the employees may feel that the ESOP is less attractive than a profit sharing plan. In an extreme case, if the company fails, the employees will lose their benefits to the extent that the ESOP is not diversified in other investments.
- **Pro Rata Offers.** Any offers to purchase stock on behalf of an ESOP must be made on a pro rata basis to all shareholders. Thus, unless the remaining shareholders agree otherwise, a retiring shareholder, for example, cannot sell his stock without offering other shareholders the opportunity to also sell stock on a pro rata basis. This is the same requirement that applies to corporate stock redemptions.

Preparing Your Company for an ESOP

Potential candidates for an ESOP include: (1) small to middle-market, closely held companies, (2) public companies and (3) large, closely held companies. A company's situation will directly influence its market value and a potential lender's assessment of its creditworthiness. The following discusses how to prepare your company for an ESOP transaction.

Small to Middle-Market, Closely Held Companies

- Financial Controls and Reporting

Many closely held companies, particularly smaller ones, have weak financial controls and reporting. Lenders rely on a company's financial statements to assess the company's creditworthiness. Consequently, the higher degree of confidence a lender has in a company's financial controls and reporting, the more consideration the potential loan will receive. Audited financial statements are recommended.

- Depth of Management/Key Man Risk

Many smaller companies lack management depth and depend on one or several key individuals, which increases the investment risk to a third-party buyer and decreases the company's market value. Furthermore, lenders are concerned with the continuity of management and, possibly, the viability of the business without key individuals. Companies in this situation should take immediate steps to develop management talent. Lenders may demand that key individuals remain on staff for a certain period after the loan is made.

- Smaller Companies Lack Diversification

Smaller companies may be dependent on key suppliers, key customers, key products and/or markets. Again, this situation increases investment risk, lowers market value and increases a lender's concern. Small companies should plan to diversify strategically in applicable "key" areas.

Public Companies

- Existing Shareholders

The fiduciary concerns of board of directors to its shareholders are heightened in the context of a public company. Consequently, the impact of the ESOP on the existing shareholders must be considered and addressed. Furthermore, well-established procedures should be followed by a company's board of directors.

- Motives

It is well-documented that many publicly held companies have established ESOPs as an anti-takeover device. Companies considering ESOPs for defensive purposes are cautioned and urged to consult legal counsel.

Large, Privately Held Companies

- Confidentiality

In many larger, privately held companies, confidentiality is critically important. These companies are advised to retain licensed ESOP financial advisors with the assistance of their legal counsel.

- Estate Planning

ESOPs can be utilized as an effective estate planning tool. Large, privately held companies should work in conjunction with their estate planning advisors when considering ESOP strategies.

Role of Investment Bankers / Financial Advisors

In general, two distinct sets of financial advisors may be necessary to facilitate an ESOP transaction: the investment banker and the ESOP financial advisor.

The Investment Banker

The investment banker is typically retained on behalf of the company or the ESOP to facilitate the following:

- Consult with the company regarding the potential price and structure of the transaction.
- *Structure a transaction* to:
  1) achieve the company's and/or selling shareholder's objectives;
  2) maximize the probability of obtaining financing; and
  3) facilitate a favorable opinion from an independent financial advisor regarding the financial fairness of the ESOP.
- Prepare a financing memorandum, a comprehensive document to facilitate a lender's review and assessment of the transaction.
- *"Shop"* for financing utilizing the investment banker's network to solicit interest from lending sources to finance the ESOP.
- *Negotiate terms of financing* to obtain the most favorable terms and pricing available.
- *Coordinate other professionals* involved in the transaction to facilitate a successful close and manage the transaction fees of other professionals.

- *Successfully consummate* the transaction in a timely manner.

The investment banker is typically compensated with a modest up-front retainer fee and a contingent fee based upon successful consummation of the ESOP transaction.

Because the stock of the corporation, rather than its assets, is being sold to the ESOP trust, the ESOP transaction is a securities transaction, as defined by law.

In the State of California "persons in the business of effecting transactions in securities for the business of others" must be registered as securities broker-dealers under both California and Federal law. Moreover, California Corporate Securities Law §25501.5, signed into law on January 1st, 2005 specifically provides the buyer of securities a five year right of recission on transactions effected by an un-licensed intermediary.

The implications for a company considering an ESOP transaction using an un-licensed intermediary are obvious: the Employee Stock Ownership Trust can demand the unwinding of the transaction for a period of five years from closing if an un-licensed person aided in effecting the transaction for the company. This could devastate the financial condition of the company and at a minimum jeopardize the issuer's ability to raise capital in the future and call into question the accounting treatment of the transaction.

All ESOP transactions Brereton, Hanley & Co., Inc. advises on are conducted through its wholly-owned, Federally registered broker-dealer to ensure that its clients are protected from this potential malignity.

The ESOP Financial Advisor

The Code requires that an ESOP investing in privately held employer stock retain an independent financial advisor, ***in certain circumstances***, such as an ESOP's purchase of employer stock from a "party-in-interest" or the ESOPs' participation in a tender offer or other larger, complex transactions, when ERISA may require the use of an independent financial advisor. Case law is reasonably well-established in the areas of "independence" and "procedural prudence." ESOP financial advisors are typically retained by the ESOP trustee or an "administrative" or "advisory committee" appointed by the board of directors in such complex, but rare instances. The ESOP financial advisor's task is to facilitate the following:

- *Represent the ESOP* in all financial matters and, where appropriate, negotiate on behalf of the ESOP.
- *Interface and coordinate* with the investment banker on behalf of the ESOP on economic issues such as the structure and design of ESOP securities.
- *Opine,* at closing, as to the financial fairness of the transaction to the ESOP.
- *Opine,* if required, as to the solvency of the transaction to the ESOP (and when required, to the lenders).
- *Opine,* at closing, as to the adequate consideration being paid by the ESOP.
- *Opine,* if required, as to the financial rights and privileges of any class of preferred stock purchased by the ESOP.

The ESOP financial advisor is compensated by a fixed fee, the payment of which cannot be contingent upon consummation of the transaction, thereby preserving the independence of the advisor. The ESOP financial advisor should have experience in ESOP transactions and have a track record of providing expert witness testimony.

Conclusion

We hope to have made clear that there are a number of powerful benefits to creating an ESOP for the selling shareholder, the company and the employees, including: tax advantages for the seller and company, increased productivity, succession strategies, and a new capital source for the company.

However, there is now a new benefit to add to the list: greater after-tax proceeds to a seller than from a third-party transaction. In today's economic climate, not only can a business owner keep control of his company and gain certainty of closure of the transaction, he or she can walk away with more cash in their pockets. This new economic and demographic reality dictates that all eligible corporations thoroughly explore the formation of an ESOP.

As with all significant transactions it is imperative to surround yourself with experienced professionals who will ask you, the company owner, the hard questions, who will tell you the truth even if it's not what you want to hear and to have advisors on your team who will put your interests above their own. Our firm has a track record of being that type of advisor. We ask you to consider engaging our firm when you decide it is time to evaluate your liquidity alternatives.

About Brereton, Hanley & Company

Brereton, Hanley & Company is a West Coast-based private investment banking firm that was founded in 1995. The firm is led by seasoned investment bankers who formerly worked for Kidder, Peabody & Company and Lehman Brothers, respectively. Through its ownership stakes in nationally respected business appraisal and ESOP third-party administration firms (ESOP Valuation Group LLC and R.K. Schaaf Associates, Inc. respectively), Brereton, Hanley is the only fully integrated ESOP service provider in America that can concurrently manage both an M&A sale process and an ESOP sale process for clients. ESOP clients benefit from this integration by receiving bundled, complete annual compliance services more competitively priced than otherwise available in the marketplace.

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Private Investment Banking
& ESOP Advisors
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