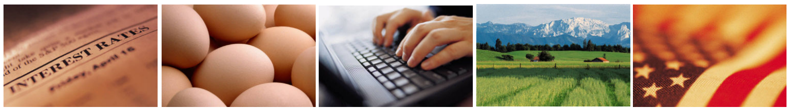


**BRERETON, HANLEY AND CO., INC.**
*Private Investment Banking & ESOP Advisory*
*- Est. 1995 -*

# Using the ESOP for Acquisitions

**April 2014**

**Introduction to the Brereton, Hanley & Co., Inc. Middle Market Corporate Finance Review**

*The Brereton, Hanley Corporate Finance Review is a periodic journal designed to assist management and investors in the middle market. The journal attempts to address and explain current and anticipated market influences, investor sentiment and the valuation implications of the economic environment; including private company acquisition activity. By introducing periodic data and highlighting critical market issues, we hope that the Brereton, Hanley Corporate Finance Review can help management and investors gain effective insight into the valuation and organization of their business.*

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## Backdrop

The confluence of cheap and plentiful debt capital with the Baby Boomer-aged retirement wave, which has begun in the middle market, has not gone un-noticed by boards of ESOP-owned companies. Rather than sit back and watch private equity sponsors re-shape industries through consolidation acquisitions, astute ESOP company management and boards are stepping up to defend their market shares with acquisitions of their own using their ESOP.

## Advantages

If structured properly, when an ESOP-owned company acquires the stock of an acquisition target, capital gains tax deferral or elimination can be passed on to the target sellers. The average all-in capital gains tax rate (including the Obamacare surcharge) is 28% nationwide—it's 36.1% for those of us in California. One-third of the transaction value to keep, share, or split is one of the best kept secrets of the middle market. The ESOP-owned company as strategic buyer will almost always be able to out-bid a private equity or other strategic buyer given this value advantage.

In addition to the price premium through tax benefits passed on to the target selling shareholders, the target's ownership/management can legitimately tell their employees that they sold the business to them, as target employees become ESOP plan participants of the new plan post close. The below table illustrates the comparative purchase price multiples for each to the transaction:

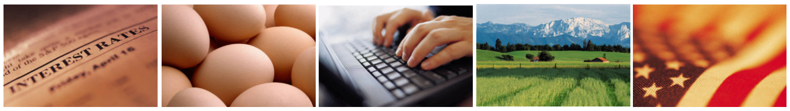
| Purchase Multiple Paid | After-tax Equivalent Paid if Taxes are Eliminated | Purchase Multiple Paid if Reduced by Tax Benefit to Target |
|---|---|---|
| 4x | 5.4x | 2.6x |
| 5x | 6.8x | 3.2x |
| 6x | 8.2x | 3.8x |
| 7x | 9.5x | 4.5x |

*Assumes 36.1% Capital Gains Rate*

## Financing Sources

Senior and especially subordinated lenders who have been advised of the ongoing tax (shield) benefits to the acquirer's (borrower's) cash-flow when the loan is used to acquire stock are *more* motivated to lend into the ESOP acquisition structure than lend into "normal" acquisition structures. The tax shield results in higher cash-flow which can provide for faster payback of interest and warrant coverage resulting in higher internal rates of return for the lender.

Separately, and unique to the ESOP acquisition structure, the target's 401(k) balance can be a source of acquisition financing. However, prudent and conservative guidelines should be followed in this connection.





## Disadvantages

The transaction structure utilized to drive the tax savings value is slightly more complex than a "normal" stock acquisition transaction structure. Resultantly, the cost of professional fees can be slightly more, though not prohibitively so.

Using the acquirer's balance sheet cash and equity (for equity-based compensation, for example) can generally reduce the per-share value of the acquirer's stock whether it's an ESOP-owned company or not, so one must be mindful of this likely post-close effect in the ESOP-owned context. Also, because the target (1) must form an ESOP immediately prior to the acquisition, which (2) eventually merges with the acquirer's plan, the per-share value of the acquirer's stock may decrease due to the increase in the total number of shares outstanding post-close.

However, "normal" (non-ESOP) stock acquisitions are typically financed with balance sheet cash, new debt or the stock of the acquirer which can result in the same effects on the buyer's valuation immediately post acquisition close. So, the disadvantages, though arguably more visible in the ESOP-owned company, have to be kept in context.

## Board & Trustee Considerations

### Directors

In the context of both "normal" and ESOP structure acquisitions company's Board of Directors enjoy very broad an deep protection afforded under the "Business Judgment Rule" when good faith decisions are made by a majority of disinterested directors regardless of the size or importance of the transaction or the potential impact on the acquirer and its shareholders if the deal fails.

To avail themselves of such protection the directors should have a well structured and maintained record of their decision-making process, which our firm takes the responsibility for structuring.

### Trustees

If the acquisition is structured in a manner requiring shareholder approval (which can be avoided), then the trustee as shareholder for the ESOP may or may not be needed for transaction approval depending on several factors. If structured correctly, however, most ESOP-company acquisition decisions can be made at the Board levels of the respective companies that are party to the transaction. Notwithstanding this, best practices and professional decorum dictates keeping the trustee "in the loop" on transaction initiatives, especially ones that can change the ownership level of the ESOP relative to other shareholders and if per-share values are likely to reduce immediately after the transaction closes.

Irrespective of actions to be or not to be taken on the part of the trustee, he/she, too, requires thoughtful and well documented decision making procedures and process. So, the acquirer's management, the respective Boards and the Financial Advisor should support this need, whether the trustee is internal or external to the company.

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Understanding what *can* be done within the ESOP-owned structure, especially strategic acquisitions which grow the earnings and long-term per-share value of the surviving company, can benefit all parties not least plan participants.

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