ESOP 101 (For ESOP Companies)

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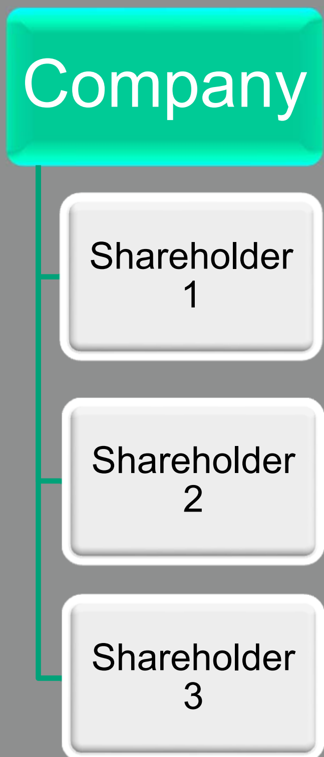
Agenda

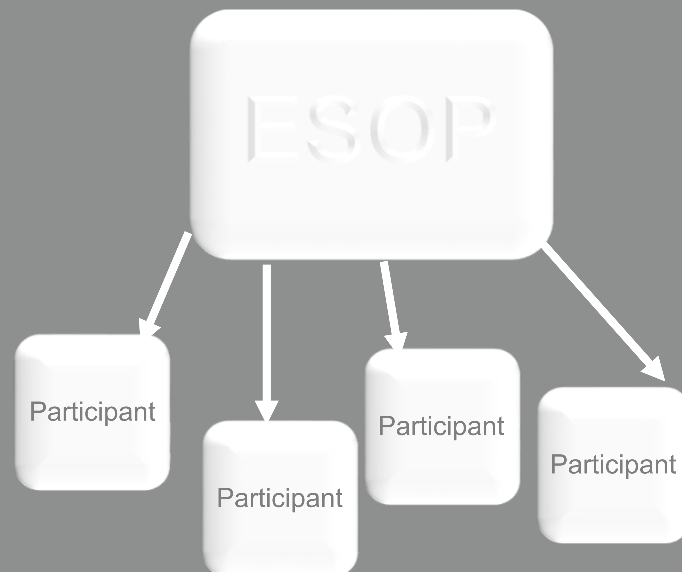
- **What is an ESOP?**
- ESOP history and facts
- ESOP mechanics
- Advantages and disadvantages
- The process and team

Ownership – 100% Transfer

Prior to sale



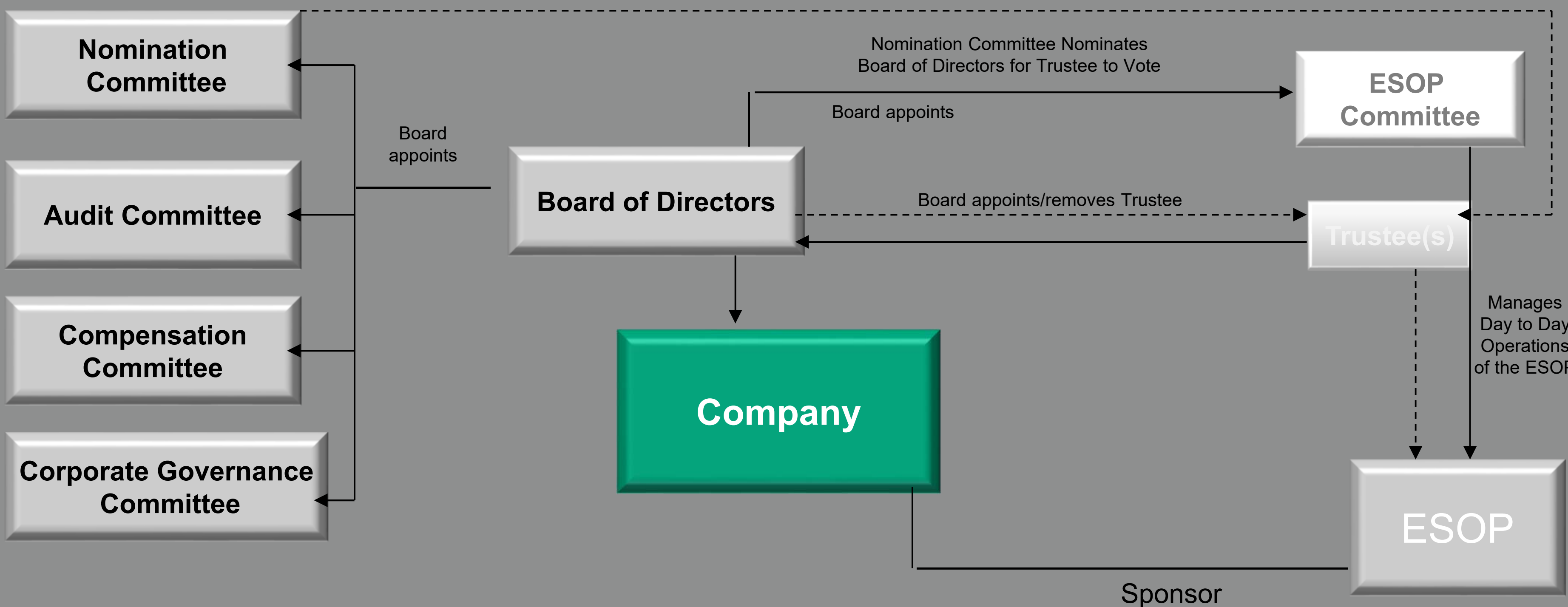
Post sale



Employee Stock Ownership Plan

Eligible employees become ESOP participants

Post Transaction Corporate Governance
For a majority ESOP



* Trustee elects Directors from nominating committee's slate

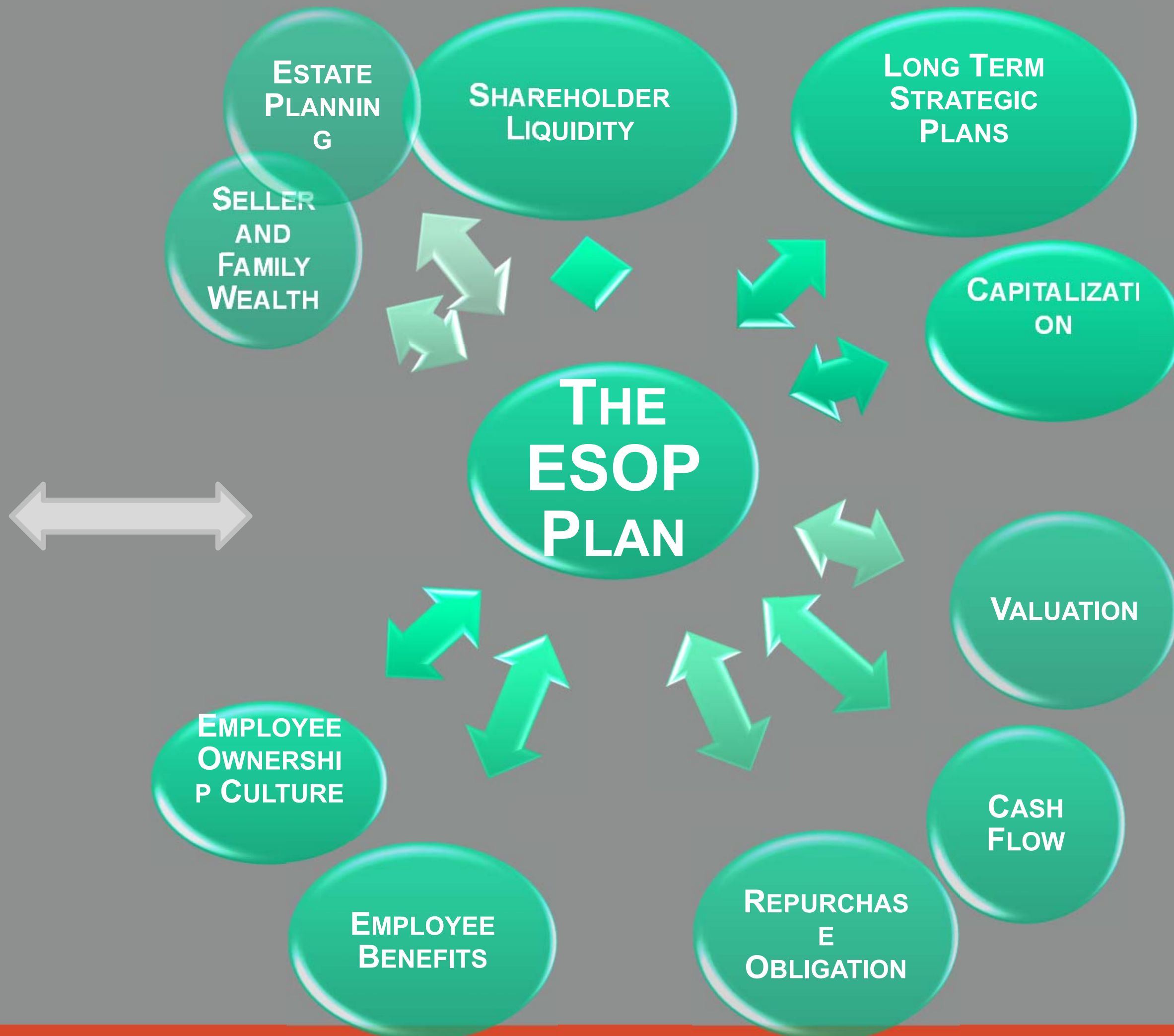
An ESOP is a retirement plan

- Qualified, defined contribution, employee benefit plan (ERISA)
  - The plan is regulated by the government (IRS and DOL)
- Invests primarily in the stock of the sponsoring company
- “Qualified” in that sponsoring company, selling shareholders, and employee participants may receive various tax benefits
  - The US government has given the company tax breaks for setting up the ESOP

Plan Design

The ESOP Plan governs

- Eligibility
- Participation
- Vesting
- Allocations / Forfeitures
- Distribution Policy
- Pass-Through Voting
- Repurchase Obligation



What is an ESOP?

- "Employee Stock Ownership Plan"
  - Retirement Plan - Qualified Defined Contribution Plan
    - Internal Revenue Code/ERISA
      - Tax-deductible contributions for employer
      - Tax-deferred growth for employees
      - Designed to invest primarily in employer stock
      - Permitted to borrow
      - Trustee
  - Corporate Finance Tool
    - Tax-advantaged financing for the company
    - Deductible dividends (in some cases)
    - S Corporation ESOPs (1998) – generally income tax exempt

What is an ESOP?

Creates Market to Sell Shares by:

- Selling all or part of shares
- Combining with management buyout
- Spreading sale of shares over many years
- Allowing offer diversification for seller
- Retaining many control elements for seller/management
- Deferring income tax potentially forever

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A Brief History:

- The Employee Retirement Income Security Act (ERISA) of 1974 created a formal legal status for ESOPs
- There are about 10,000 ESOPs in the U.S., covering over 10.3 million employees (10% of private sector workforce)
- 5,000 ESOP companies are majority-owned by the ESOP and approximately 4,000 are 100% owned
- About 330 ESOPs, or 3%, are in publicly-traded companies
- At least 70% of ESOP companies are, or were, leveraged

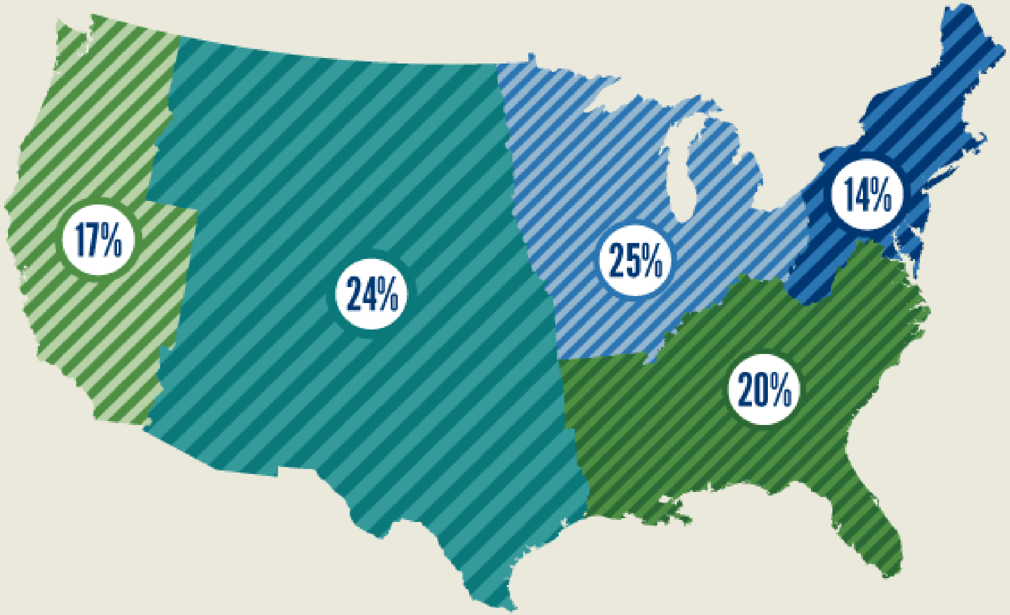
HISTORY OF ESOPS

A Brief History of Employee Ownership

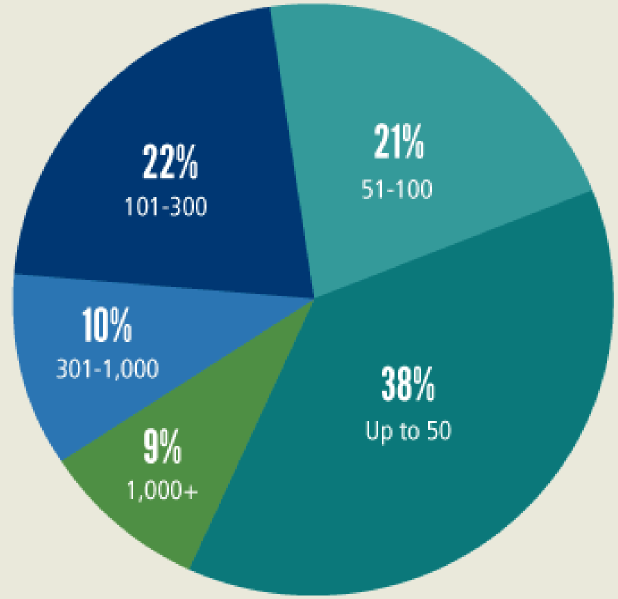
Year	1956	1974	1998	2013
Event	Peninsula Newspapers establishes first ESOP.	Federal government creates statutory frame-work for ESOPs.	Congress passes the legislation expanding ESOP incentives.	Today, the ESOP commu-nity employs more than 13 million people.
# of ESOPs	1 ESOP	200 ESOPs	9,700 ESOPs	10,900 ESOPs
Participants	Under 200	250,000	6.3 million	13 million

www.esopinfo.org

Geography of ESOPs

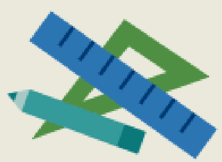


Number of Employees

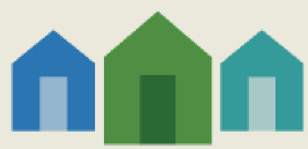


Most Common Industries

Manufacturing



Engineering



Construction

Banking

www.esopinfo.org

ESOP Statistics

- 10,000 ESOPs in U.S., covering 10.3 million employees (10% of the private sector workforce)
- ~5,000 majority owned by the ESOP
- ~4,000 are 100% owned by the ESOP
- Found in all industries
- 72% of The ESOP Association's members are companies with fewer than 250 employees
- At least 70% of ESOP's are or were leveraged, i.e. they used borrowed funds to acquire stock bought by the ESOP
- As small as a few dozen employees and as large as 84,000

(Source: The ESOP Association 08/2013)

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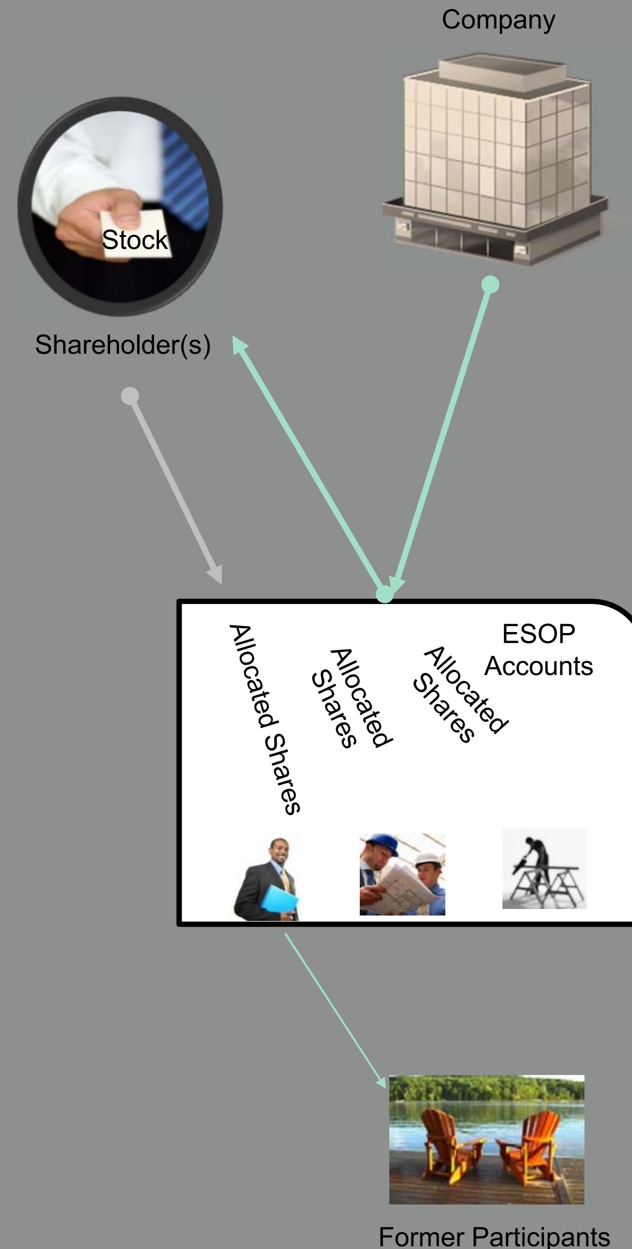
TRANSACTION DESIGN ALTERNATIVES

- Non-leveraged
- Progressive
- Redemption and sale
- Leveraged
- Combination

Non – Leveraged

- Company sets up an ESOP Trust
- Company makes annual tax deductible contributions in cash or stock to the ESOP trust
- Cash is used to buy stock from current shareholders
- Shares are allocated to the accounts of eligible employees within the ESOP, typically based on salary
- ESOP holds stock for participants and annually notifies them of how much stock is in their account and the value of the stock in their account
- Employees collect stock or cash, according to a vesting schedule, when they retire or otherwise leave the company



Leveraged ESOPs

The ESOP receives a loan to purchase stock from current shareholders

- These stock is held in trust and released into employee accounts at a rate corresponding to debt amortization

Financing Alternatives

ESOPs typically acquire a block of stock with leverage (“debt”) funded by one or a combination of:

- Bank(s)
- Excess company cash
- Private equity group (PEG)
- Selling shareholder(s)
- Management investment (rare)
- Broad-based employee investment (rare)
- Combination (typical)

100% Leveraged ESOP
with Seller Debt

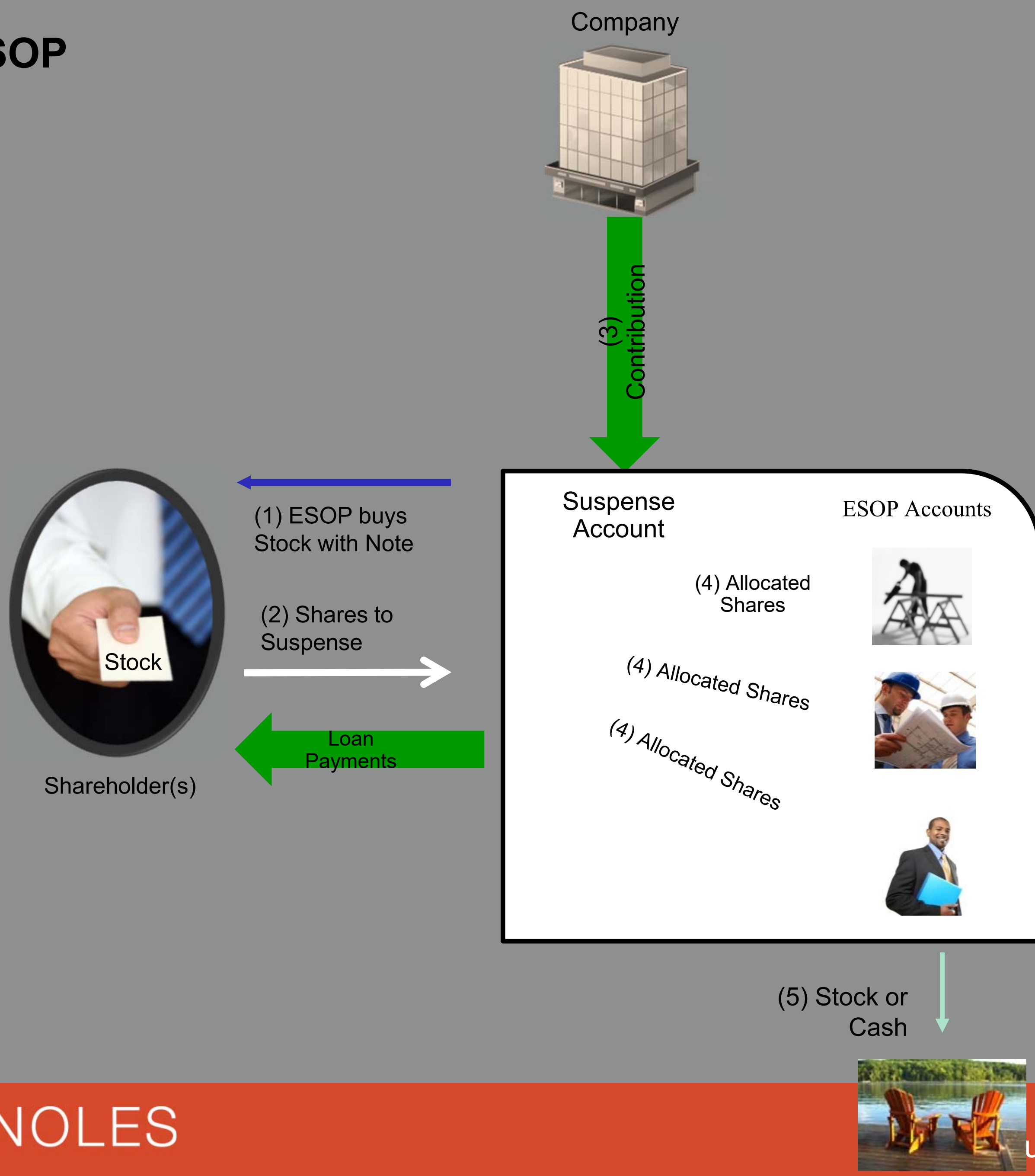
(1) ESOP buys stock from existing shareholders with a note

(2) Shares are held in Suspense Account

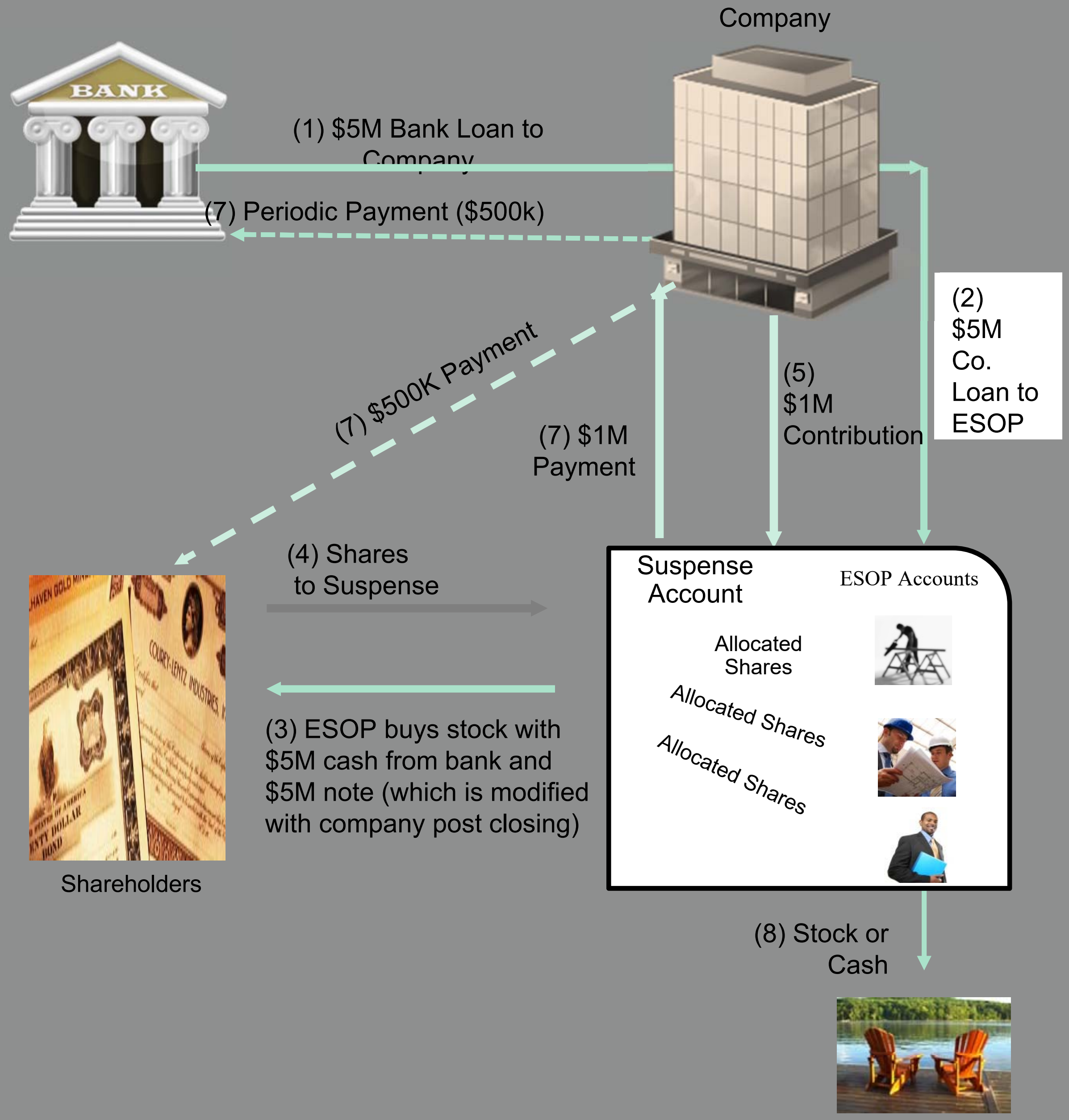
(3) Company makes annual tax-deductible contributions to ESOP to repay seller and bank debt

(4) Shares are released from suspense account and allocated each year as ESOP repays sellers with contributions

(5) Employees receive stock or cash when they retire or leave (vesting applies)



100% Leveraged ESOP (Bank and Seller Debt)



$10M Value
$5M Bank debt
$5M Seller Notes

(1) Bank lends $5M to company

(2) Company lends $5M to ESOP

(3) ESOP buys stock from existing shareholders

(4) Shares are held in suspense account

(5) Company makes annual tax-deductible contributions to ESOP to repay seller and bank debt

(6) Shares are released from suspense account and allocated each year as ESOP repays company loan

(7) The ESOP then repays company, who then repays the bank and sellers

(8) Employees receive stock or cash when they retire or leave (vesting applies)

How is stock price determined?

By law the ESOP may not pay more than fair market value as determined by an independent valuation firm and trustee

Company's stock price will be determined annually by the ESOP Trustee based on an independent valuation firm's determination of fair market value

- ESOP Trustee
  - Expertise in ESOP trustee services
  - Appointed to act on behalf of ESOP participants
- Independent Valuation Firm
  - Independent and experienced in valuation
  - Utilize expertise, experience, industry standards, and guidelines provided by IRS

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Tax advantag es

- Tax-deductible principal repayment [IRC 404(a)(9)]
- Tax-free S corporation income [IRC 409(p) and 512(a)]
- Tax-deferred sale - C corporation stock [IRC 1042]
- Tax-deductible dividends “C” corporation [IRC § 404(k)]
- Contributions may be reimbursable under federal government cost-plus contracts
- ESOPs are frequently utilized in addition to a 401(k) plan

Advantages

Company

- Substantial tax savings
- Increased cash flow
- Pre-tax dollars repay debt
- Tax-free income, S Corp ESOP stockholder not subject to federal and most states mirror

Stockholders

- Liquidity in part or whole
- IRC 1042 “tax-free” rollover
- Selling shareholders can remain involved (if desired)

Employees

- Share in equity growth
- Research shows ESOP companies more likely to have other retirement-oriented benefit plans
- Proven motivator
- Retains key employees

Disadvantages

- Requires debt to purchase larger blocks of stock
  - Seller can finance
  - Bank and bonding approval must be considered
- Repurchase obligation
  - Planning for funding options important
- The tax favors and employee benefits can be spectacular
  - Compliance with regulations: IRS, DOL, ERISA
- Complexity
  - Experienced advisors essential

TAX STATUS CONVERSION

- C to S or S to C
- IRC 1042 “tax-free” rollover as C Corporation transaction, then convert to S Corporation
- S Corporation convert to C for “tax-free” Rollover – five-year wait to convert to S
- 100% shareholder approval for S Corporation election

Benefits to Participants

Benefits to Employee Participants

- Added retirement benefit
  - Allocation of ESOP assets (cash and/or stock) usually in proportion of salary to covered payroll
- Tax deferred until payment received
- Employee owner – power to affect own wealth/retirement

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THE PROCESS

Preliminary Analysis	• No cost • Confidential • 30,000 foot view
Phase I Decision Package	• Valuation estimate • Feasibility study, creating a "decision package"
Phase II Implementation	• Plan and trust, and transaction documents • Financing • Repurchase obligation planning/funding • Independent transaction valuation
Phase III Ongoing	• Employee communications • Repurchase obligation • Annual administration and valuation

ESOP team

- Trusted advisors
- ESOP consultant
  - Prepares feasibility study, the decision package, to ascertain viability and "quarterbacks" implementation
- Corporate counsel and CPA, other advisor(s)
  - Supporting and advising as needed
- Third party plan administrator
  - Handles annual record keeping and compliance testing
- Independent appraiser
  - Determines fair-market value
- Trustee(s)
  - Acts on behalf of the ESOP and purchases stock
- ESOP counsel
  - Drafts plan, trust and transaction documents
  - Advises trustee(s) and other fiduciaries

Other Items

Common ESOP Fables

- Employees will run the company – False
- Employees will access financial/confidential information – False

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