SBA Loans for ESOP Transactions

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Benefits of an ESOP

1. ALWAYS AVAILABLE: Create a Buyer anytime, not subject to market conditions
2. PRIVACY: No sharing strategic matters with current, or potential, competitors
3. CONTROL: Limited execution risk & high probability to close
4. MANAGEMENT: Less alienation from failed process, no effort to transfer control to strangers

Benefits of an ESOP (cont.)

5. SPEED: Close in 3 months, while maintaining control of the timeline
6. LEVERAGE: vs. Dividend Recap, Banks fund larger EBITDA-multiples given tax benefits
7. TAX SHIELD: Multiple benefits
8. DIVERSIFICATION: Wealth management specialists can diversify investment of proceeds into sectors with counter-cyclical features vs. sponsor company

Government Contractors Only: ESOP expense can be built into rates on CPFF contracts

Leverage Overview

ESOPs can be “unleveraged” with no cash changing hands at settlement

OR

ESOPs “leveraged” with:

- Senior & Mezzanine (or uni-tranche), and/or Private Equity to provide liquidity to Seller at settlement,
- Seller Note, or
- Combination of the above

Old Way With SBA

- SBA has been authorized to loan to ESOPs since 1979, but program requirements were out-of-line with commercial ESOP lending and overly burdensome—in other words, no one wanted to use it!

- In 2018, my firm and a few other national ESOP advisors worked with Senator Gillibrand's office to draft legislation to re-tool the ESOP SBA 7(a) loan program to make it more a more viable option for smaller ESOP candidates.

Old Way With SBA (cont'd)

- ONLY direct loan to ESOP was allowed—ESOP had to be borrower, Company guarantor
  - Company paid ~$140,000 guaranty fee, no seller guaranty and Company served assets as collateral

- Loan proceeds could only be used by ESOP to purchase stock (no other fees, costs, expenses)

Old Way With SBA (cont'd)

- SBA did not allow ESOP 7(a) loans under the Preferred Lenders Program (PLP) making loan approval *especially cumbersome* and time consuming as all review and approval had to come directly from SBA National Office (who never seemed to have staff that understood ESOPs)

- Unworkable definition of "Qualified Employee Trust" for ESOPs that included requirement of full pass-through voting rights for ESOP participants—a rarity in the ESOP world

Old Way With SBA (cont'd)

- No Seller guaranty if sold 100% AND Seller exited Company, BUT equity requirement (in form of Seller Notes) between 10% - 25% of transaction value
  - Could remain involved for 1 year as a "consultant"
- Selling Shareholders who remained involved with Company (remained owner) had to provide personal guaranty

SBA ESOP Purchase

- ESOP OWNERSHIP: ESOP typically ends the day at 100% when SBA is involved
- BORROWER: Can now be either ESOP or Company
- MAX LOAN SIZE: SBA Loans up to $5M; “mezzanine” thereafter
- INTEREST RATE: Base rate (prime, LIBOR) + 2.75%
- “SMALL” ELIGIBLE: $15M Net Worth; $5M Net Income
- SELLER EXIT: No longer required to avoid Seller Guaranty even if ESOP acquires 100% interest in Company
- COLLATERAL: Company assets only; no minimum requirement
- OTHER LOANS: A/R Lines, FF&E loans; junior term debt
- EQUITY: Seller Note Min. 10% (Stage 2) to 25% (100% Stage 1); now, it is up to SBA’s discretion

Main Street Employee Ownership Act of 2018

- The "qualified employee trust" definition has been updated to only requiring pass-through voting for major corporate matters in accordance with Code § 409(e)
  - (as opposed to previously requiring full pass-through voting of ESOP participants on all matters requiring shareholder vote)

- SBA Loan proceeds can now be used to fund ESOP stock purchase as well as to pay "*associated transaction costs*"

Main Street Employee Ownership Act of 2018 (cont.)

- A plan to purchase the stock of a small business concern can be submitted by the trustee of a qualified employee trust <u>*or a small business concern*</u>
- For a loan made to a trust:
  - A seller of the small business concern <u>may remain as an officer, director, or key employee when the trust or cooperative acquires 100% ownership of the concern</u>; and
  - A seller who remains the owner of the concern must provide a personal guarantee to the SBA (i.e. Seller of less than 100%)

Main Street Employee Ownership Act of 2018 (cont.)

- A loan made by a small business concern to a qualified employee trust does not need to contain the same terms as the SBA's loan to the concern—Allows for back-to-back "conventional" loans
- The SBA Administrator can choose not to require the provision of mandatory equity by a qualified employee trust as a condition of the loan
- Increased requirements on SBA for reporting on employee-ownership initiatives and outreach to promote employee ownership

Considerations for Increased Leverage Opportunities

1. 100% ESOP-owned S corporations neither pay, nor pass through, any federal income tax liability, thus supporting larger senior financing

2. Government contractors can pass through the cost of repaying the loan on their Cost Plus contracts as “fringe,” thus supporting larger senior financing

Single-Stage ESOP: Conventional vs. SBA (EV@5x EBITDA)

Conventional	SBA
Conv. Senior Bank Debt: - Amount: ***1.5x*** EBITDA - Amortization: 3 to 5 years - Seller Collateral: Some proceeds - Seller Guaranty: Possibly	SBA Bank Debt: - Amount: ***3.5x*** EBITDA - Amortization: 7 to 10 years - Seller Collateral: No - Seller Guaranty: No
Mezzanine Debt: - Amount: ***2.0x*** EBITDA - Amortization: 5 to 7 years - Rate: 12%, plus warrants	Mezzanine Debt: None
Seller Note: - Amount: 1.5x EBITDA - Amortization: negotiable	Seller Note: - Amount: 1.5x EBITDA - Amortization: 2yrPIK + term out

Case Study #1

- Government Contracting service/consulting firm in Northern Virginia
- Company Value ~ $6.4M
- Pre-Transaction Shareholders = ESOP 40%, Seller 60% (i.e. Second Stage ESOP Purchase)
- Stock Purchase: 60% for $3.84M (2012)
- Company revoked S-Election at Closing to take advantage of larger amount of ESOP contribution limits
- No SARs or Warrants

Case Study #1

ESOP Purchase Financing:

- SBA Loan:
  - Loan amount = $3,456,000
  - 7 year term
  - Loan Fee = $94,700 (paid by Company)
  - SBA Review/Approval < 2 months
- Seller Note:
  - Note amount = $384,000 (10% equity requirement)

Case Study #1

- Outcome:
  - ESOP went to 100% shareholder (40%-100%)
  - Selling Shareholder (Trust of deceased founder) received $3.456M in cash + $384,000 Seller Note
  - No Seller Guaranty because no Seller involvement after sale (not even consulting agreement) and 10% Seller Note
  - Company got approval from Bank to prepay Seller Note within 1.5 years
  - SBA Loan was repaid within 4.5 years using combination of contributions and dividends

Case Study #2

- Healthcare IT Company in Minnesota, Company value ~ $8.5M
  – Pre-Transaction Shareholders: 4 Selling Shareholders, 2 largely involved in Company, 2 loosely involved (focused on other business interests)
- ESOP purchase of 100% for $8,461,571
- Company revoked S-Election prior to Closing, Sellers made 1042 elections of varying percentages
- SARs-yes, Warrants-no

Case Study #2

ESOP Purchase Financing:

- SBA Loan:
  - Loan Amount = $5,000,000
  - 10 year term
  - Loan Fee = $138,125 (2017)
  - SBA Review/Approval < 4 months
- Seller Notes:
  - Aggregate Note Amount: $3,461,571 (~40% equity)
  - Two tranches

Case Study #2

- Outcome:
  – ESOP became 100% shareholder (0%-100%)
  – Selling Shareholders received $5M in cash + $3.461M in Seller Notes
  – No Seller Guaranty because Sellers left (2 Sellers took 1-year consulting agreements) and 40% Seller Notes
  – SAR Plan worked to retain executives who stepped in upon Sellers' exits
  – Sellers used cash portion of proceeds to reinvest and elect 1042

Kaufman & Canoles, P.C.
ESOP Implementation Services

- ESOP feasibility analysis
- Valuation and financial consulting
- ESOP transaction design
- ESOP financing and funding
- Legal plan documents
- IRS and other regulatory filings

Q&A

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