

Creative Ideas for Succession and Liquidity

Business Succession, the ESOP Value Proposition, and Alternatives

Innovative Solutions

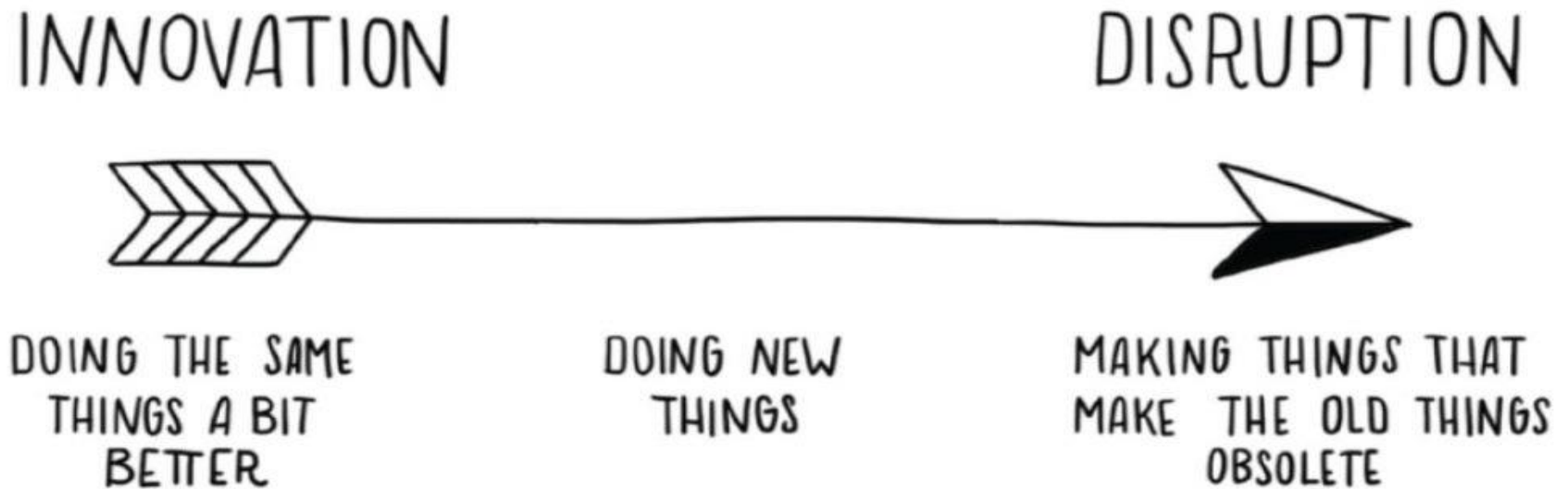


John Vitucci, Principal

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Are you a Disrupter or a Victim?



In business sometimes, insanity can be defined as doing the same thing and expecting a different result!



Market Trends: Talent

Market trend/reality

Fast-changing market



Fast-changing technology



Demographic shift – It's really happening



Expectations of transparency and individualization



The average student will have

10 - 14

jobs before age 40

Baby boomers retiring at the rate of

1 every 9 seconds

between now and 2029

Percent of children entering school today that will end up in jobs that don't exist yet

65%



Public Company Disruption

S&P 500 Churn Over the Past Decade

Sample companies that have entered and exited the index since 2002

Entered the index:



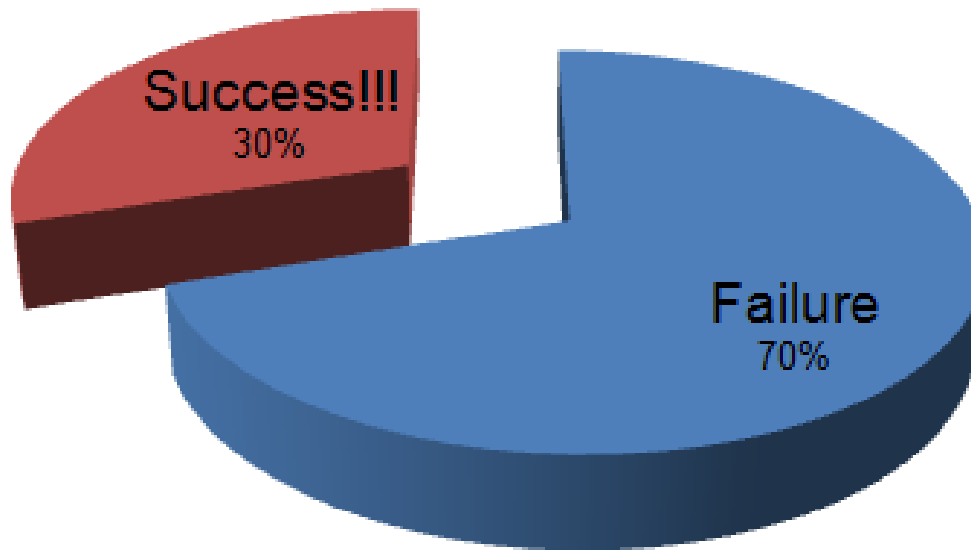
Exited the index:





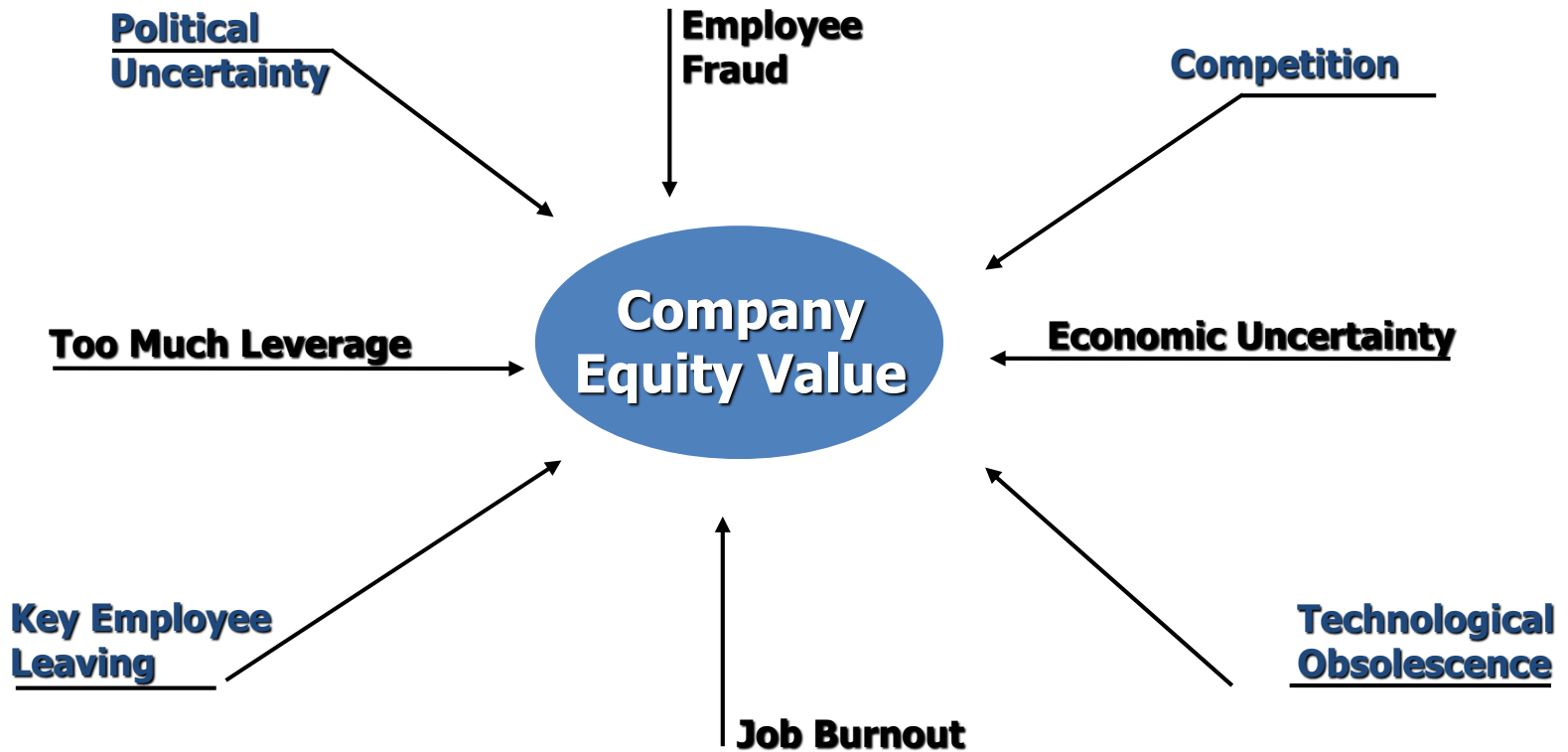
Family Business Disruption

Family Businesses Going Into the 2nd Generation





Equity Value of a Private Business at Risk



Why are Business Owners not Liquid?

Most entrepreneurs have greater than 80% of their net worth locked up in an illiquid investment, due to:

- Day-to-day time constraints
- Lack of knowledge of possibilities
- Bad advice
- If it isn't broke don't fix it
- Family ownership
- Inertia

No second layer of management available to take over business

Seller is too much of a key employee, without the key employee there is no business left to sell



Retirement Plan Optimization

Category	EBITDA	401(k)	Pension Plan	ESOP
1	EBITDA <\$1M	Yes	Potentially	No
2	\$1M<EBITDA<\$2M	Yes	Yes	Maybe
3	EBITDA >\$2M	Yes	Yes	Yes

- Typical company may have a 401(k) plan – maximize deduction to approximately \$55,000 per individual with safe harbor or profit sharing
- Over time may consider sponsoring 401(k) plan and Pension Plan – deduction of \$55,000 in 401(k) plan and depending on age per individual approximately \$250,000 per year deduction for Pension Plan
- Can also consider ESOP – higher potential distribution based on share value and account value at retirement





Exit or Succession Plan

A monetization event or a sale of a private business can be accomplished in a number of ways:

- Leveraged recapitalization – limited by level of bank financing but business is not sold
- Taxable sale to a third party such as private equity. However, not every business is easy to sell or can be sold without ongoing participation by business owner
- Sell to employees using a book value approach – lower sale value and is usually utilized by professional service firms such as accounting firms or engineering firms
- Tax Free Sale to an ESOP - Use of leverage, must buy replacement property and business owner can get warrants in company
- Taxable Sale to ESOP - business owner participates in ESOP



Hypothetical NJ Company

- One business Owner owns 100% of S Corporation in NJ
- The business has \$10 Million of EBITDA and is valued at \$50 Million
- The owner takes a \$500,000 salary and pays \$5 million a year in Federal & State Taxes
- The Business has 50 employees excluding the owner
- Taxable Sale to ESOP - business owner participates in ESOP
- The business owner takes a 10 year seller note paying 6% interest in exchange for the sale
- What is the value proposition?



ESOP Opportunity

- Special tax rules applicable to ESOPs for S Corporations
- Benefits of employee ownership to shareholders, management team and employees
- An ESOP can be utilized as an effective succession planning tool
- In situations with seller financing, selling shareholders can be repaid with improved cash flow of the business due to ESOP tax benefits
- In certain situations, selling shareholders that provide seller financing can participate in the ESOP (if they continue employment with the company)
- Distributions from the Firm to ESOP can offer diversification and bankruptcy protection
- An ESOP can be combined with a 401(k) plan

- ESOP trust is a permitted S Corporation shareholder
 - 100 shareholders or less
 - No nonresident aliens, certain types of trusts, or corporations as shareholders
 - One class of stock
 - Stock must confer identical rights to distribution and liquidation proceeds
 - Differences in voting rights are disregarded
- ESOP trust is a tax-exempt entity - special UBIT exemption applies to ESOPs
- S corporation earnings not taxed to the extent of ESOP ownership – participants taxed when benefits are distributed from the ESOP

An ESOP Explained

- Tax-qualified plan – Must satisfy eligibility and coverage testing, nondiscrimination testing, vesting and other qualified plan rules
- ESOP requirements
 - Invested in “qualifying employer securities”
 - Pass-through voting rights on major issues
 - Diversification rights for participants age 55 with 10 years of participation
 - Right to elect benefit distributions in shares of stock– allowed to pay in cash (put option)
 - Special timing of distributions at termination, retirement, death or disability
 - Permitted to borrow funds



S Corporation Anti-Abuse Provision

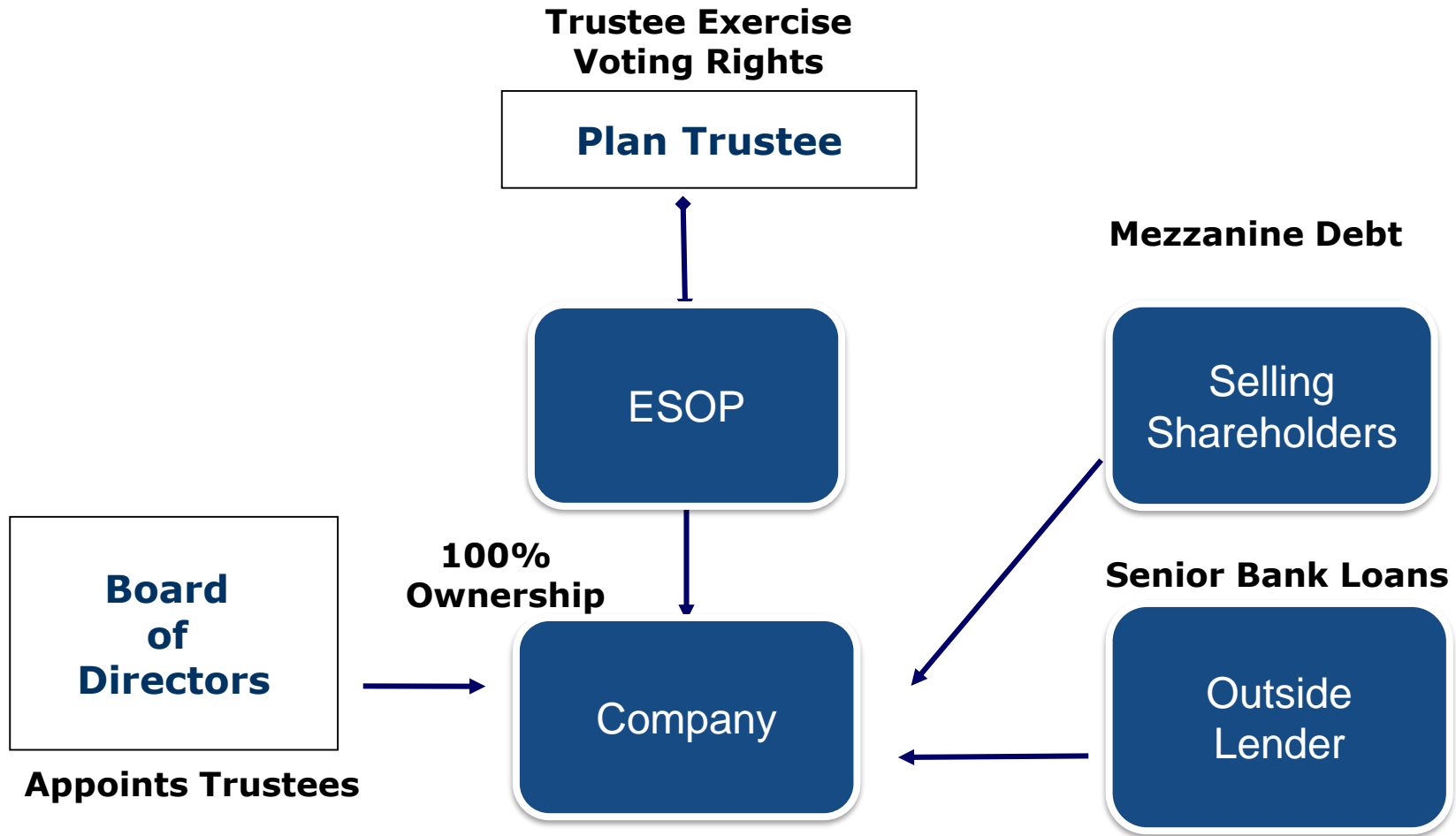
- Addresses concerns that ESOP-owned S Corporations were being designed to unfairly concentrate the ownership in the hands of only a few
- Non-allocation Year – any time during the plan year that disqualified persons own at least 50% of the number of shares of stock in the S Corporation
- Failure to comply results in:
 - 50% excise tax
 - Deemed distribution of the value of the ESOP account
 - Disqualification of ESOP
 - Prohibited transactions, and
 - Unrelated Business Taxable Income (UBTI)

Repurchase Liabilities

- Where an ESOP distributes employer securities that are not readily tradable on an established market, the employees participating in the ESOP retain a put option granting them the right to sell the employer securities to the employer at fair market value
- Some strategies to satisfy the employer's obligation to repurchase these securities include:
 - Funding out of current cash flow (pay-as-you-go)
 - Prefunding through additional cash contributions or utilization of ESOP distributions
 - Debt
 - Other



Post Closing -100% ESOP Ownership





Valuation Methods

Discounted Cash Flow

Guideline Public Comparables

Guideline Transactions

Liquidation Value



Financing Issues

- There are several potential sources of debt financing
 - Senior Lenders – Asset Based
 - Senior Lenders – Cash Flow Based
 - Mezzanine Funds
 - Seller Financing
 - Structured Equity

- General Lender Considerations
 - Collateral Base (real estate, inventory, receivables, etc.)
 - Cash Flow
 - Character
 - Strength of the management team

Players Involved in ESOP Transactions

The Company

- Accountant and/or Consultant
 - ESOP Micro Feasibility Analysis
 - ESOP Transaction Design
 - Manage ESOP Implementation Process
- Company Financial Advisor
 - Valuation
 - ESOP Macro Feasibility Analysis
 - Debt Placement
- Legal Counsel
 - Assist in ESOP Transaction Design
 - Draft ESOP Documents

The ESOP

- ESOP Trustee
 - Valuation & Fairness Opinion to Trustee
- ESOP Trustee's Financial Advisor
- ESOP Trustee's Legal Advisor

The Selling Shareholder

- Financial Advisor
- Accountant
- Legal Counsel
 - Review Transaction Documents

ESOPs by Industry Group

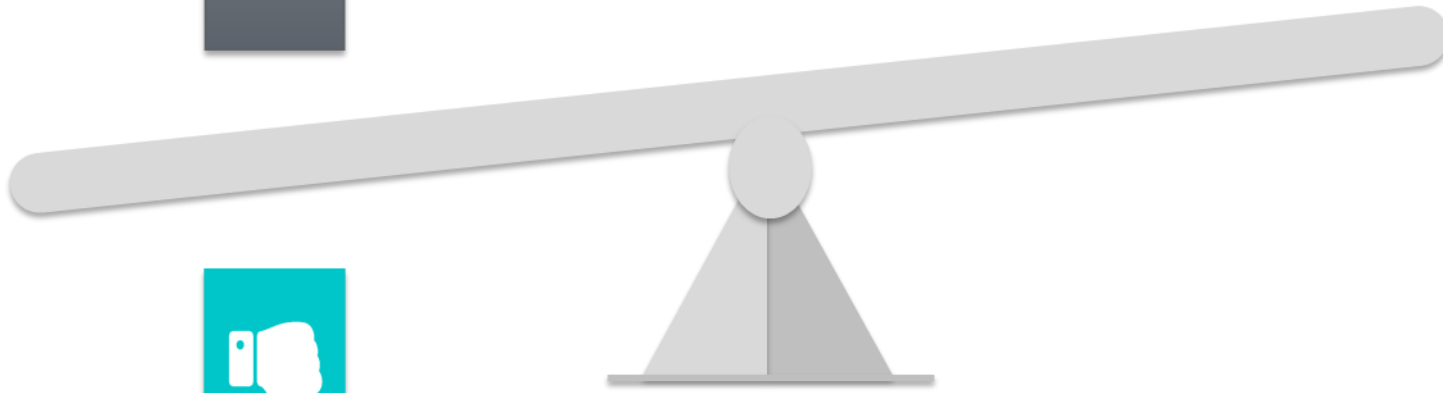
Industry	Percentage of ESOP Companies
Manufacturing	22.4
Professional/scientific/technical services	17.6
Finance/Insurance/Real Estate	17.2
Construction	10.7
Wholesale trade	9.3
Retail trade	5.8
Agriculture/Mining/Utilities	3.1
Management	2.8
Services	2.3
Health care	2.2
Waste management	2.06
Transportation	2.04
Information/Technology	1.7
Other	0.6



ESOP Pros & Cons



- Controllable transaction
- Shorter transaction timeline
- Ownership culture / retirement benefits
- Retains and attracts key employees
- Flexible financing arrangements
- Significant tax incentives



- Perceived complexity
- Full liquidity at closing is unlikely
- On-going administrative costs
- Non-productive debt on balance sheet
- Repurchase obligation

John N. Vitucci, CPA

John N. Vitucci is a Principal in the Employee Benefit Services Group of PKF O'Connor Davies, LLP and has more than 30 years of experience working with Fortune 500 corporations and investment banks in all areas of employee benefits, executive compensation and ERISA. John is currently an adjunct professor at Columbia University where he teaches Pensions & ERISA and Oral Communications for Actuaries in the Actuarial Masters Program.

John was a senior partner at a Deloitte Tax LLP where he worked for 24 years. He was the National Employee Benefits Leader, Northeast Employee Benefits Leader and member of the Northeast Tax Management Committee. His primary focus was on ESOPs, serving clients and the development of new employee benefit products. He was previously a pension specialist with the Employee Plans Division of the Internal Revenue Service.

John has as spoken at numerous seminars on employee benefits, has published many articles, and has been quoted in numerous publications, including *The Wall Street Journal*, *Forbes & the Financier*. He previously chaired the Employee Benefits Committee for the New York State Society of Certified Public Accountants. He was the chairperson of Foundation for Accounting Education's 1994 and 1995 Employee Benefits Conference. He was a contributing editor of the employee benefits column for *The CPA Journal* for 4 years.

Professional Affiliations

Member of the American Institute of Certified Public Accountants
Member of the New York State Society of Certified Public Accountants
Member of the ESOP Association and National Center for Employee Ownership
Advisory Board Member for Rutgers NJ/NY Center for Employee Ownership

Accreditation

New York State Certified Public Accountant

Education

Pace University, Bachelor of Business Administration degree in Accounting



JVitucci@pkfod.com

T: 908-967-6834

M: 917-841-8718