

ESOP's as an Effective Planning Tool

Presented by:

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Business Transition Advisors, Inc.

- Providing services in all 50 states
- Drawing on 75 YEARS of combined team experience
- In the last 5 years BTA has worked with:
 - Over 8,100 employees
 - 455 stockholders
 - *Market values of over \$1.75 BILLION DOLLARS!*

Unique Features

- Since Congress believes that having employees accumulate retirement income is beneficial to society, it provides 3 major tax incentives to ESOP's:
 1. Stock sold to ESOPs can qualify to defer/avoid capital gains tax
 2. The company can receive a dollar for dollar deduction for stock sold to the ESOP
 3. The company can become State & Federal Income tax free

Uses of ESOPs

- **Business Owner Exit Strategy/Next Generation Transfer**
- **Liquidity/Diversification for Closely Held Stock**
- **Partner Buy Out**
- **Desire for Employee Owned Culture**
- **Divorces/Immediate Cash Needs**
- **Enhanced Employee Benefits/Handcuffs**
- **Mergers & Acquisitions**

Traditional Option Concerns

- All traditional sale methods use after-tax dollars
- ESOP's utilize **pre-tax** dollars

Traditional Option Concerns

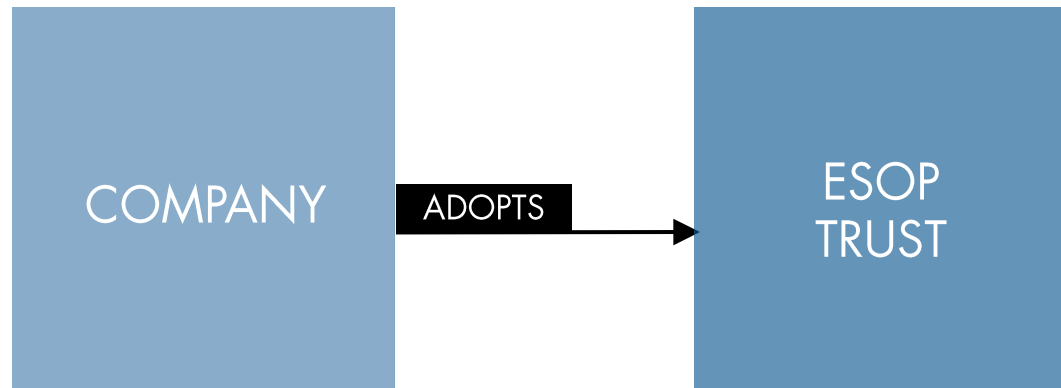
\$10,000,000 Business Value

Non-ESOP	ESOP
\$16,666,000 Earnings Required	\$10,000,000 Earnings Required
\$6,666,000 Corporate Tax	\$10,000,000 Deduction
\$10,000,000 Net After Tax	\$4,000,000 Tax Savings*
\$2,920,000 Capital Gains Tax	
\$7,080,000 Net to Seller	10,000,000 Net to Seller

Tax Savings Over \$10,000,000

- Assuming 40% Combined Federal & State Tax Rate
- Assuming 29.2% Avg. Combined Federal & State Capital Gains Tax Rate

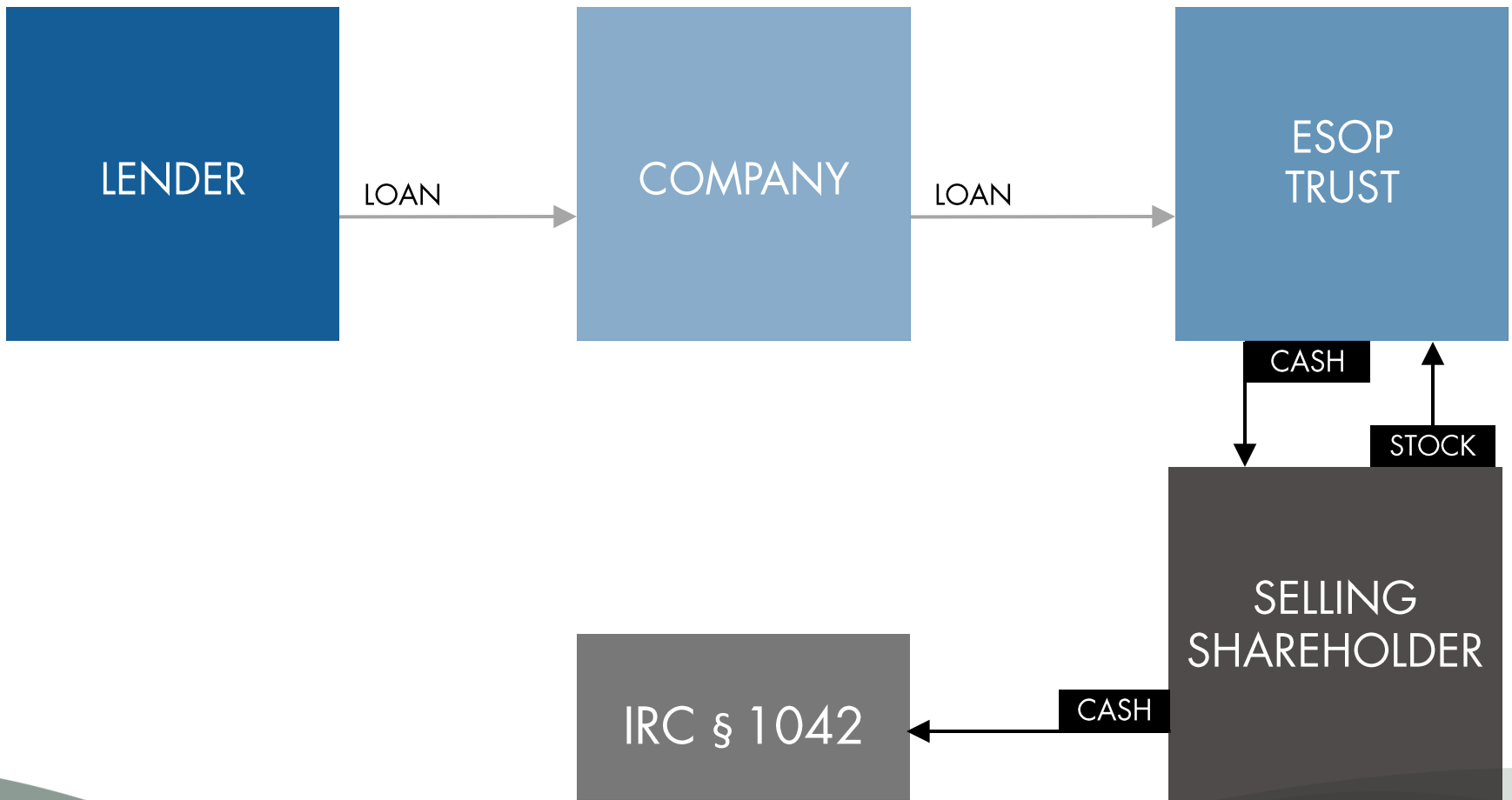
How an ESOP Works: STEP 1



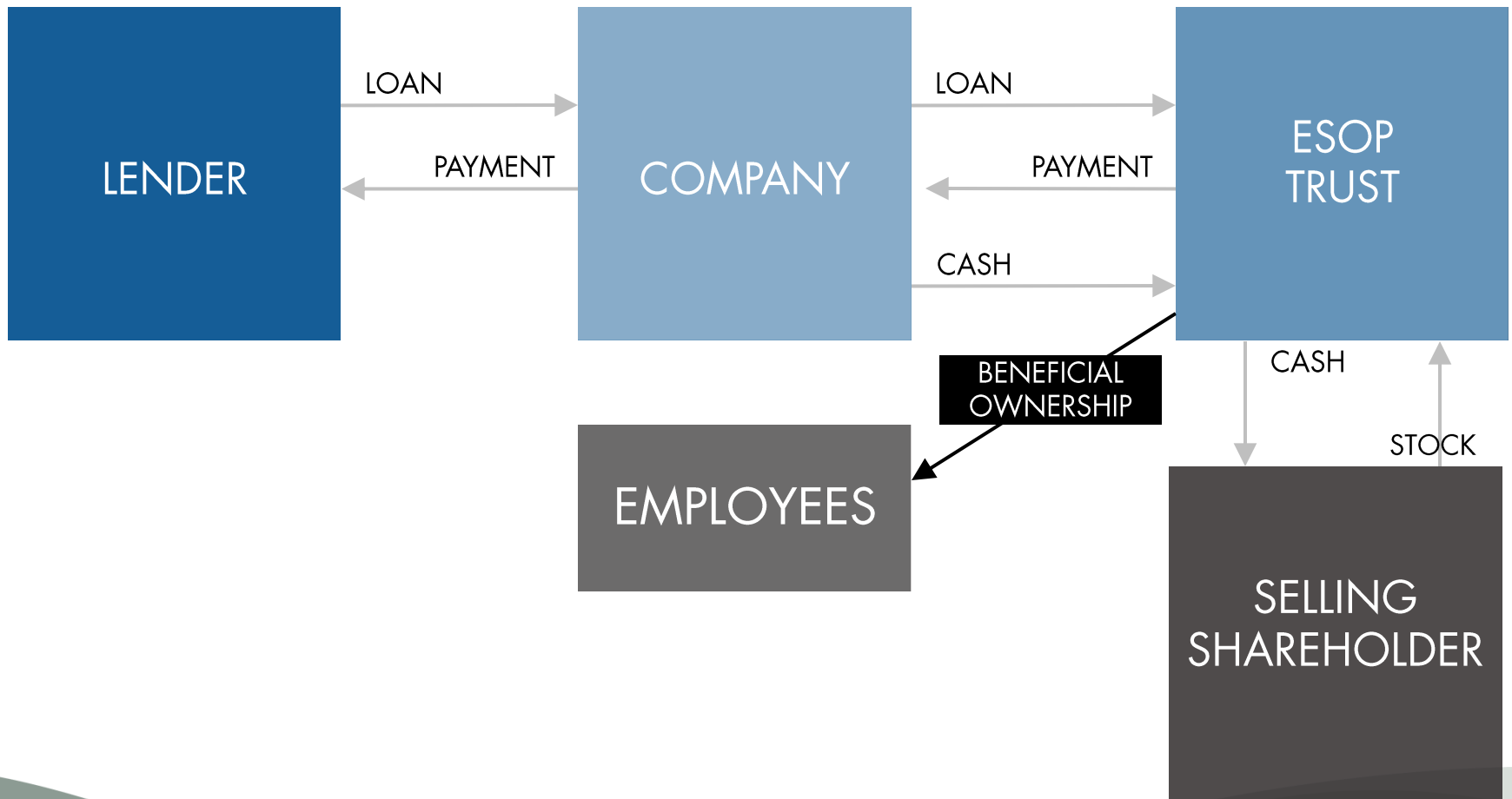
How an ESOP Works: STEP 2



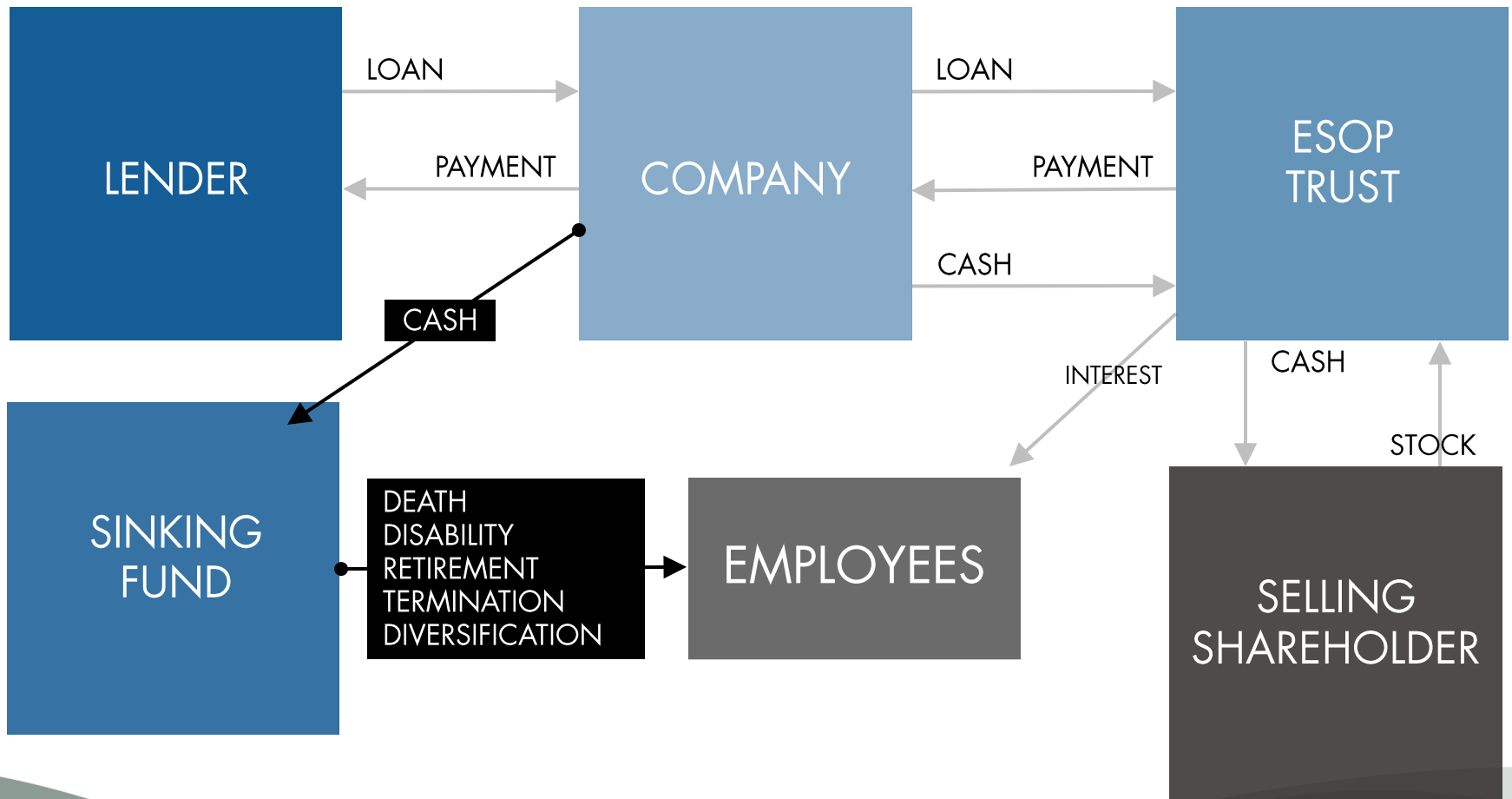
How an ESOP Works: STEP 3



How an ESOP Works: STEP 5



How an ESOP Works: STEP 6



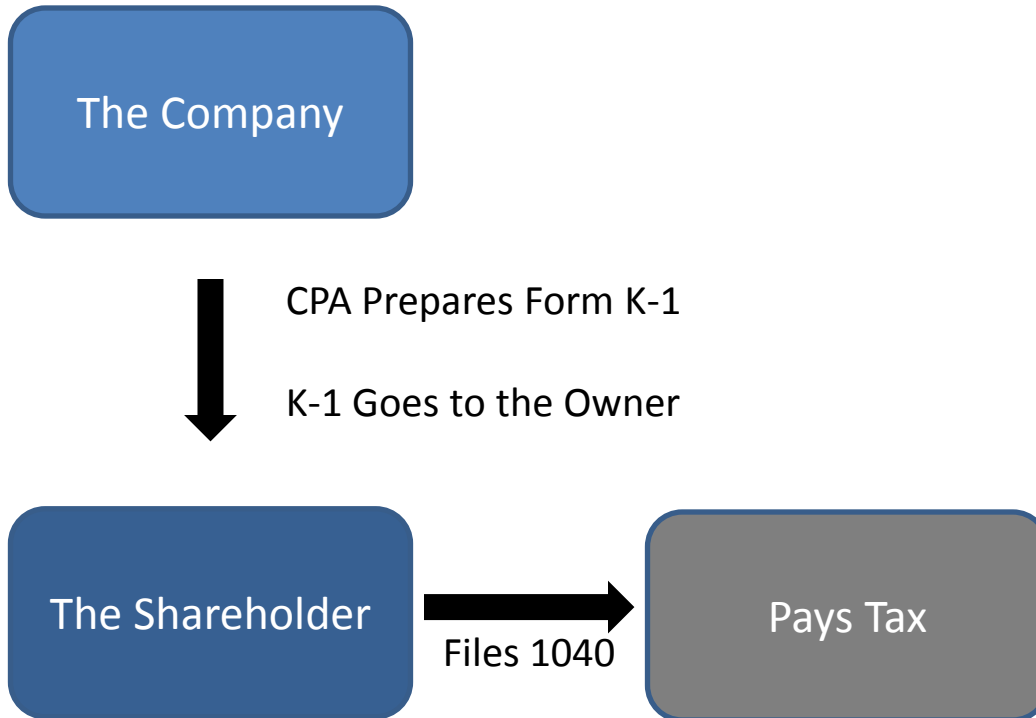
IRC § 1042 Tax Deferral

- Selling shareholder may elect to indefinitely defer all capital gains on sale proceeds regardless of basis
- Similar to real estate provision IRC § 1031 and life insurance IRC § 1035
- Requirements set at a relatively “low bar”
- Financial products specifically made to facilitate liquidity of IRC §1042 assets

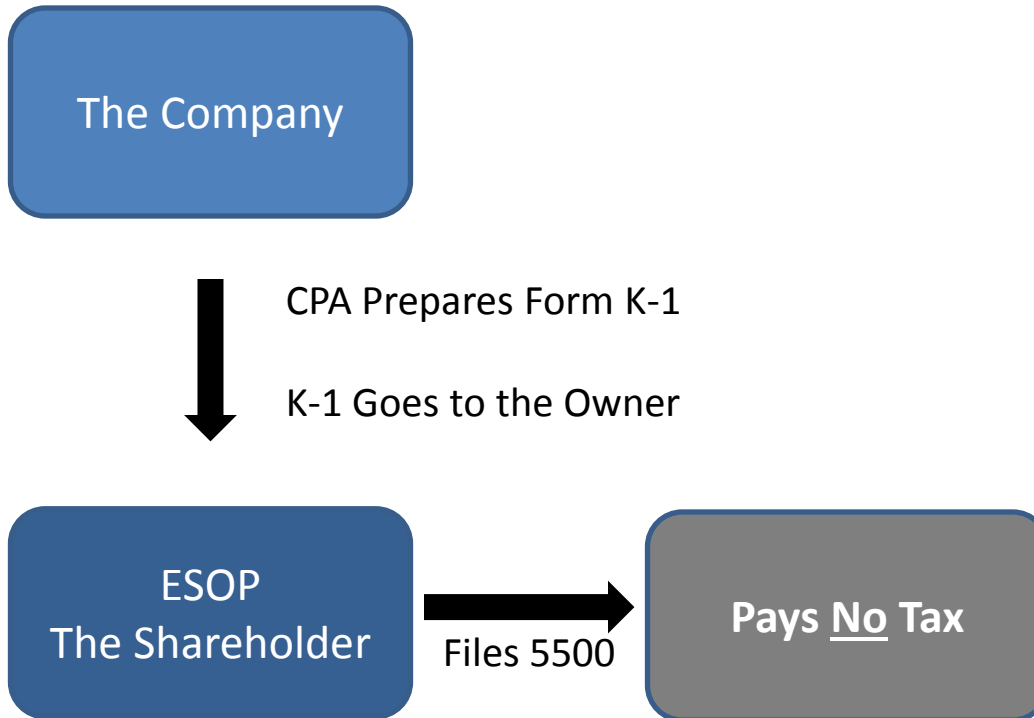
100% “S” Corporation ESOP

- Pays no Federal or State corporate income tax to the extent ESOP owned
- Taxation is “passed through” to shareholders in proportion to ownership
- An ESOP is tax exempt, therefore no tax is paid on percentage owned by the ESOP
- Corp does not have to distribute income
- Exempt from prohibited transaction rules

Taxation of “S” Corporations Before the ESOP



Taxation of “S” Corporations After 100% Sale to the ESOP



Corporate Governance

IF YOU CONTROL THE BOARD OF DIRECTORS YOU CONTROL THE COMPANY

- Corporate control
 - Shareholders Elect the Board of Directors
 - Board of Directors appoints the Officers
 - Officers responsible for day-to-day operations

ESOP Corporate Governance (Privately Held Company)

In An ESOP

- Board of Directors appoints the ESOP Trustee
- The Trustee votes the stock

How Do We Finance the Buy Out

- Financing an ESOP is normally done with a combination of bank debt and other debt or equity from outside parties
- The owner can take a note back for some or all of the stock sale amount

Capital Structure: Need to Finance 100%

LEND 2-3X EBITDA

SENIOR
BANK DEBT

40 – 60%
OF THE EQUITY

Capital Structure: Need to Finance 100%

FROM PRIVATE
EQUITY - EXPENSIVE
12-14%

MEZZANINE
FINANCING

20 - 30%

SENIOR
BANK DEBT

Capital Structure: Need to Finance 100%

V.C. CAN BE EVEN MORE EXPENSIVE
20% +

VENTURE CAPITAL

20 - 30%

MEZZANINE FINANCING

20 - 30%

SENIOR BANK DEBT

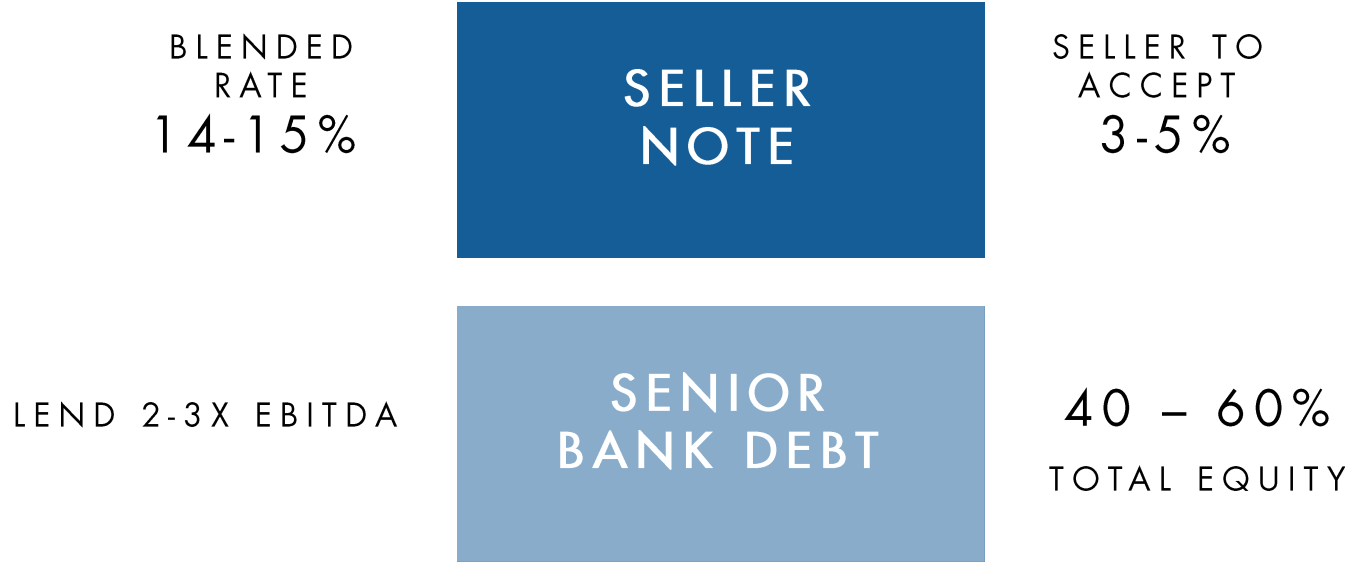
40 - 60%

100%

Recommended Structure

- The Seller is entitled to a Market Rate of Interest
- Instead of going to the market for all the financing, we recommend the seller take a note for everything above senior debt
- The interest rate can be adjusted to suit the seller's goals and the company cash flow

Capital Structure: Need to Finance 100%



Warrants to the Seller

- Since the Seller is willing to accept a lower rate of interest on the seller note portion, warrants are issued to “make up” the difference in the lower interest rate.
- This allows Warrants to be issued that can be 25-35% of the total equity of the company

Warrants to the Seller

- The Warrants are then able to be exercised once all the debt (both Bank and Owner) is paid off
- The owner receives a 2nd bite of the apple
- If the company grows and is successful, the Warrants can be extremely valuable to the owner

Corporate Finance

Warrants

- Right to purchase company stock at a future date at a fixed price
- Priced “post transaction”
- Must be valued by qualified valuator
- Gives the seller a “2nd bite of the apple”
- Warrants can be give to management or family members in the business

ESOP Candidate Profile

- Owner wishing to cash out all or portion of business
- Payroll of \$1,000,000 or greater
- Strong succession management
- \$5,000,000 or more business value
- 15 + Employees
- Low cost basis

Success Stories

Industrial Cooling Southeast \$7 million	Payment Processing Southwest \$35 million	Energy Reseller Southwest \$300 million	Civil Engineering Southwest \$45 million	Manufacturing Company Southwest \$15 million
Engineering Consulting Southwest \$20 million	Plastic Molds Industry Northeast \$7 million	Concrete Construction Northwest \$16 million	Pharmaceutical Company Southwest \$125 million	Drilling Company Southwest \$6 million
Pet Food Industry Southeast \$60 million	Electrical Design Southwest \$18 million	Civil Engineering Southwest \$6 million	Shipping Receiving Northwest \$10 million	Machine Tool Manufacturer Northeast \$6 million
Aerospace Engineering Northwest \$14.5 million	Weapons Research Southwest \$4 million	PEO/Workers Comp Southwest \$12 million	Grain & Flour Products Northwest \$58 million	Steel Fabrication Northeast \$29 million
	Engineering Services Northwest \$8 million	Telecommunication Industry Northwest \$40 million	Financial Services Southeast \$14 million	

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