The Anatomy of a Successful ESOP Transaction

Acquiring 100% of the stock of

The Ace Company, Inc.

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The Process of Creating an ESOP

- Extensive process to establish the ESOP was completed on the employees' behalf – with checks and balances to ensure a proper structure with fair terms for employees

- Qualified Independent Trustee was retained to represent the employee owners in establishing the ESOP and negotiating the transaction. The Independent Trustee retained the following experts to assist in the transaction:
  - Financial Advisor
  - Legal Advisor

- The Trustee and its advisors negotiated with the sellers and their financial and legal advisors to arrive at fair terms for the new employee owners

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- **Adopted** as of January 1, 2011
- **ESOP acquired** 100% of company on October 31, 2011
- **Trustee**
- **Trustee financial advisor**
- **Trustee legal advisor**
- **Company financial advisor**
- **Company legal advisor**
- **Participant Recordkeeper**

Transaction Assumptions

- **Company**
  - C-Corp and needed to be S-Corp post-transaction
  - Value was $15 million on a control non-marketable basis
  - Senior debt capacity to borrow was $5MM to fund an ESOP transaction plus $3MM of balance sheet cash at closing – in addition to its working capital borrowing needs
- **Shareholders wanted:**
  - Liquidity
  - Maximize their value from the sale
  - Minimize their capital gains taxes from the sale
  - Primary shareholder wanted to retire after closing
  - Incentivize management to take over and run the business to assist in getting all transaction debt repaid building equity value for ESOP participants
- Shareholders willing to fund part of the deal with subordinated seller notes
- Existing management wanted a management buyout using an ESOP structure

Transaction Issues

- Control transaction with an ESOP – potential conflicts of interest between buyer and sellers
- Valuation concerns for sellers - must negotiate an acceptable valuation for sellers that will work for ESOP Trustee
- Tax planning for sellers – to minimize seller capital gains taxes from sale
- Tax planning for company – to reduce (i) taxes in the year of sale as a C-Corp, and (ii) to eliminate post-transaction company taxes as an S-Corp for the following FYE and beyond
- Need proper incentives for management to be structured into transaction – Retention Units will cause dilution to the ESOP. Performance SARs may not cause dilution
- Seller's desire to obtain a market level return on the financing they held in the transaction
- Seller's ability to effectuate control while they are still owed monies on their seller notes from the company

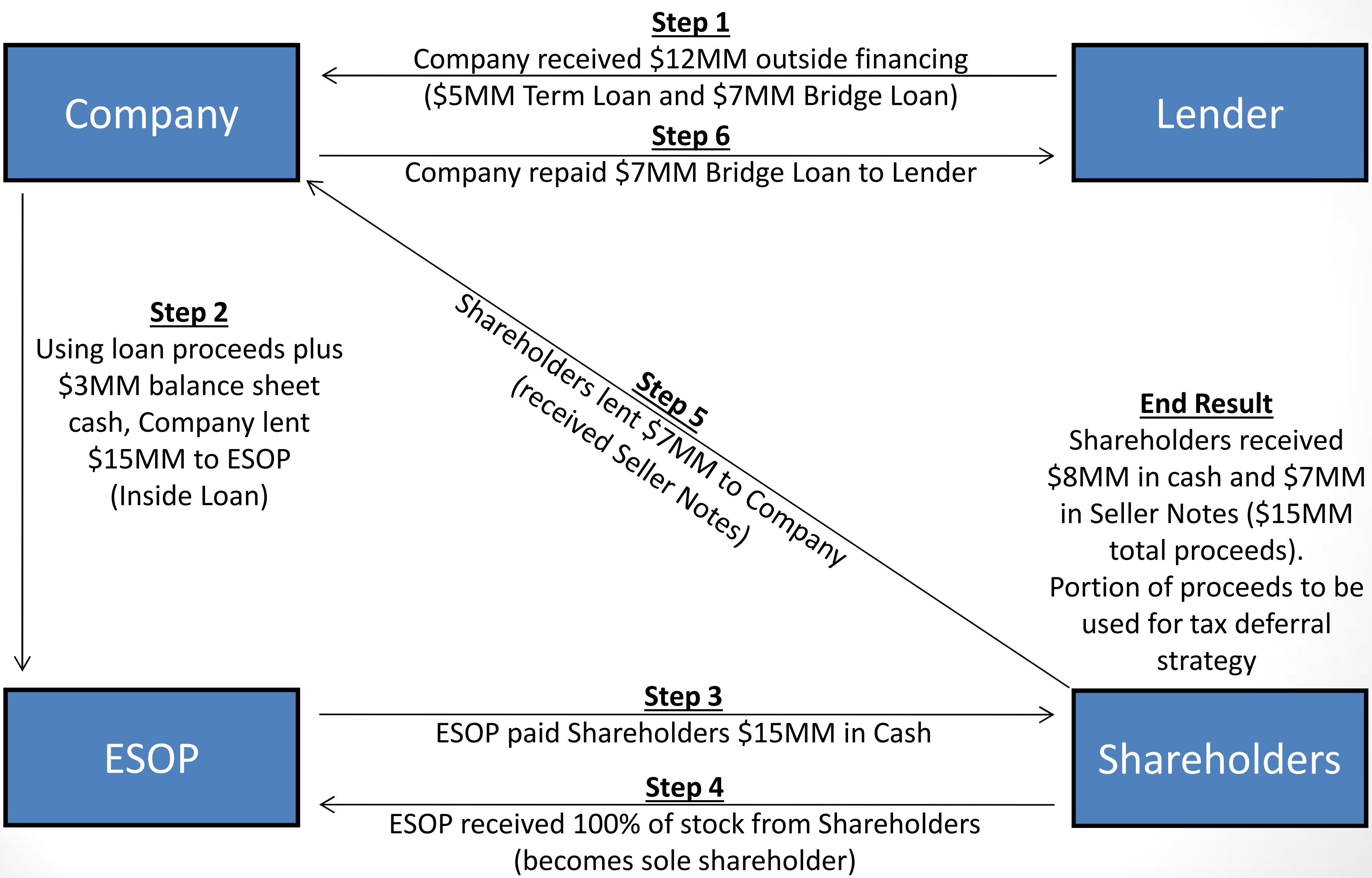
Potential Solutions

- Sell 100% to the ESOP and create a tax-exempt entity
- Retain an independent ESOP Trustee and its team of advisors to represent the employee owners in the transaction
- Trustee financial advisor issues a fairness opinion considering the effect of all transaction terms to the ESOP participants (from a financial point of view) in addition to adequate consideration opinion
- Design transaction to qualify for a IRC 1042 capital gains tax deferral to enable sellers to defer all capital gains taxes from the sale, possibly permanently
- Mitigate corporate taxes in the year of sale as a C-Corporation by using ESOP contributions and possibly tax-deductible dividends
- Company can make an S-Corp election on the beginning of its next fiscal year (post-transaction) and operate as a tax-exempt entity, indefinitely
- Design a management incentive plan into the transaction in the form of Stock Appreciation Rights up to 15% of company's equity value in a separate pool outside of the ESOP and solely for key management employees. Some retention units, most performance based units
- Negotiate/structure ability of Sellers to control the board (as a covenant of their seller debt) until their seller notes are fully repaid – at which point that right would expire

Potential Solutions

- Sale price is $15MM
- Company borrows $5MM and uses $3MM of balance sheet to fund transaction – represents upfront cash of $8MM
- Sellers take subordinated seller notes for $7MM (initially funded as a bank bridge loan of $7MM and is loaned back to the company to create the subordinated seller notes)
- Sellers received a 13% annual return on their notes comprised of 5% annual cash interest plus the balance of their return in warrants – that will be redeemed from them after all transaction debt is repaid, so that on a look-back they would have realized a 13% annual return on their notes
- Transaction closed in late October 2011
- Shareholders deferred all capital gains taxes from the sale under IRC 1042
- Company converted to an S-Corp on 1/1/12 and became a tax-exempt entity as a 100% ESOP owned S-Corp

The 100% ESOP Buyout Case Study



End Result

- Shareholders received $8MM in cash for sale and $7MM in notes for a total of $15MM for 100% of company
- Seller notes anticipated to be repaid within 5 years, possibly through a bank refinance. All debt estimated to be repaid in 6 to 7 years
- Existing management runs the business and Sellers are involved at board level until their seller notes are fully repaid – at which time that right expires
- Sellers have the ability to defer capital gains taxes from sale. Assume combined tax rate of approx. 25%, capital gains tax savings of approx. $3.75MM
- Company elects S-Corp status on beginning of its next fiscal year (1/1/12) and operates as a tax-exempt entity and uses pre-tax dollars to repay all transaction debt on an accelerated basis
- Management owns up to 15% of the company in a separate management incentive plan with most of the units (SARs) issued overtime based on performance
- Sellers supplement their total return on their seller notes with warrants (ownership units in the company) to be redeemed after all transaction debt is repaid to get to a 13% IRR

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Overview

- Founded in 1960 in Boise, ID.
- Privately held C-Corp, four company consolidation, two owners, some family members on management team.
- One owner advancing in age wanted to monetize his investment and retire.
- Core competencies include high precision machining for the wood tooling, food processing, semiconductor, LCD, and medical fields.
- 125 employees.
- One company in consolidation targeted for sale.
- Management team wanted to continue the business.

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Transaction Perspectives & Considerations

- Strong conservative financials, but not sufficient to buy back stock internally.
- Initially focused on M&A transaction, but concerned about tax implications to company and departing owners.
- ESOP considered, but little understanding by owners.
- Concerned about continuity, succession, and employees.
- Solid banking relationship with existing lender
- Overview meeting with company financial advisor helped answer questions.
- ESOP seemed to be the closest alternative to MBO.
- ESOP appeared to be a win-win situation for owners, management and employees.

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Looking Back – Reasons for Success

- Flexible transaction allowed us to accommodate needs/wants of each party involved. (unique ESOP process)
- We spent considerable time ensuring we hired a professional/experienced team including company financial advisor, external independent trustee with its own advisors, attorneys, etc. We wanted it done right the first time.
- Insisted on face to face meeting and company tour.
- Made decisions when we had to and not any earlier.
- Excellent organization and exchange of data.
- Were coached and prepared to orchestrate through challenges along every turn.
- Our advisors coached and prepared us for life after the transaction.

Legal Issues to Start Deal

- Review of engagement agreements
  - Appropriate indemnification standards
  - Is the trustee conflicted?
  - Is the trustee's financial advisor an independent valuation expert?
  - All fees are budgeted and agreed to

- Analyze deal structure for tax and securities law issues to assure that stated objectives are met

- Creation of the ESOP – a generous employee benefit plan and purchaser of company stock
  - Plan must be customized to meet the objectives of the company and its participants while including safeguards to appease other transaction interests (i.e. lender concerns)

Kick-Off Due Diligence Meeting

- Offsite
- All transaction players attend
- Agenda and summary transaction profile distributed in advance
- Presentations & Q&A
- Agreed upon timeline for key events
  - Seller LOI
  - Trustee meeting
  - Trustee response to LOI
  - Complete negotiations
  - Documentation
  - Closing
- Site visit

Due Diligence

- Electronic data room
- Financial and operational due diligence
- Legal due diligence

Trustee Committee Meeting

- Documents presented prior to meeting
  - Presentation book
  - Draft valuation report/work papers
  - Legal due diligence memo
  - Seller LOI

- Presentation

- Outcome: Negotiation Parameters Obtained
  - Price
  - Loan terms
  - MIP terms
  - Note and Warrant terms
  - Employment contract terms
  - Board composition – independent directors

Negotiation Approach

- Responses in writing
- Timely responses
- Realistic counter offers
- Consider the entire package
- Final term sheet

Other Issues

- Funds flow memorandum
- Plan provisions
- 409(p) testing
- Life insurance on sellers

Questions?

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