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.
The Ace Company, Inc.

- **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

Step 1
Company received $12MM outside financing
($5MM Term Loan and $7MM Bridge Loan)

Step 2
Using loan proceeds plus $3MM balance sheet cash, Company lent $15MM to ESOP (Inside Loan)

Step 3
ESOP paid Shareholders $15MM in Cash

Step 4
ESOP received 100% of stock from Shareholders (becomes sole shareholder)

Step 5
Shareholders lent $7MM to Company (received Seller Notes)

Step 6
Company repaid $7MM Bridge Loan to Lender

End Result
Shareholders received $8MM in cash and $7MM in Seller Notes ($15MM total proceeds).
Portion of proceeds to be used for tax deferral strategy.
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.
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?
Contact Information

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