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Current ESOP Transaction Structuring Alternatives

THE CONFERENCE & TRADE SHOW for ESOPs

Current ESOP Transaction Structuring Alternatives

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Agenda

I. New & 2ND Stage Transactions – Current Trends

II. Financing Trends – New & 2nd Stage Transactions

III. Releveraging Transactions – Repurchase Obligation Management Tool

IV. Structuring Acquisitions for an ESOP-Owned Company – Providing Tax Savings to Target's Sellers

V. Financing ESOP Company Acquisitions: A Structuring Overview

NEW & 2ND STAGE TRANSACTIONS – *CURRENT TRENDS*

New ESOP Transactions - Trends

Description

- More companies and sellers are considering minority/staged ESOP transitions
- Switch to C-Corp, take 1042; remain C-Corp for 5 tax years

Considerations

- Less financial leverage allows companies to tolerate taxes as C-Corp.
- Tax reform lowered C-Corp tax rates, reducing tax burden
- Greater control over delivery of benefit to employees over time

New ESOP Transactions - Trends

Description

- Some companies converting to C-Corp and still selling 100% in single transaction
- Switch to C-Corp, take 1042; remain C-Corp for 5 tax years

Considerations

- Higher leverage of 100% deal and corporate taxes adds financial risk
- Tax reform lowered C-Corp tax rates but also limited interest deductibility
- Forces companies to maximize contributions, resulting in less control over pace of benefit delivery

2nd Stage ESOP Transactions - Trends

Historically has been sale to ESOP by shareholders but sellers are increasingly considering redemptions of non-ESOP instead

Description

- Company redeems shares from sellers – ESOP not a direct party to transaction
- Avoids value dilution to ESOP shareholders

Considerations

- Sellers can't defer cap gains taxes
- Less regulatory risk because ESOP is not transacting
- Use of warrants may draw less regulatory scrutiny as ESOP is not transacting

FINANCING TRENDS - *NEW & 2ND STAGE TRANSACTIONS*

Financing Trends - New / 2^{nd} Stage

Senior banking financing remains predominant financing source, with excess purchase price generally financed with seller debt. However, non-bank, institutional unitranche lenders have been more active.

Description

- Blend in single loan of senior/2^{nd} lien/mezz term debt funded up to 4x – 5x EBITDA
- Less principal amortization and easier structural terms

Considerations

- Much more expensive – by as much as 500 bps
- Prepayment penalties lock companies into higher pricing structure, preventing use of cash flow enhanced by tax savings to reduce debt

Financing Trends - New / 2nd Stage

Unitranch alternative would be separate senior/mezz (or second lien) tranches

Description

- Separate bank & mezz loans
- Bank – typical terms; mezz - little or no amortization, looser terms
- Accelerate bank debt repayment; reload bank debt, refinance mezz after prepayment penalty period

Considerations

- Mezz much more expensive – 10%/12% cash pay + PIK
- Transaction risk – bank and mezz lender will need to negotiate intercreditor arrangements
- Higher transaction costs
- Seller note may generate similar liquidity over short term via excess cash flow recapture payments

RELEVERAGING TRANSACTIONS – *REPURCHASE OBLIGATION MANAGEMENT TOOL*

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Releveraging

- Releveraging can take many forms, but generally speaking it is when the Company has been redeeming shares into treasury and then reissues these shares on a NEW ESOP Loan.
    - Financed with a loan from the Company to the ESOP – typically with long amortization schedule
    - The shares are placed into suspense and allocated over time

Releveraging

- Why do Companies Releverage?
  - Manage Repurchase Obligation (“RO”)
  - Adjust Benefit Level
  - Alleviate the “Have & Have Nots” Issue

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Releveraging

- Recent Trend: Enhanced Releveraging
- “Redo” the ESOP Transaction (Extreme)
  - Outside Bank Borrowing
  - Company Redemption of Shares
  - 401(k) Subscription – Disclosure Documents
  - Combination

Releveraging

- Releveraging Complications
  - Is This In the Best Interest of the ESOP?
  - Effect on Participants and the Company
  - Multi-Tranches
  - Price Protection & Dilutive Impacts
  - Adequate Consideration / Fairness

STRUCTURING ACQUISITIONS FOR AN ESOP OWNED COMPANY – *TO PROVIDE TAX SAVINGS TO THE TARGET'S SELLERS*

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Overview of ESOP Acquisition Structure With 1042 Option for Target's Sellers

- Target company creates its own ESOP, which is then subsequently merged into the acquirer's ESOP
- Both acquirer and target will need their own ESOP trustee, ESOP financial advisor, and ESOP counsel
- ESOP trustees to agree on exchange ratio of acquirer stock for target stock
- Both ESOP trustees likely need a fairness opinion
- Sellers receive all cash
- Strategy will allow for target selling shareholders to receive a capital gains tax deferral under I.R.C. 1042

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The following notwithstanding, there are alternative, potentially simpler ways to complete an acquisition and offer the sellers 1042, but that encompass varying levels of tax risk to the acquirer and sellers and thus are outside the scope of this presentation today

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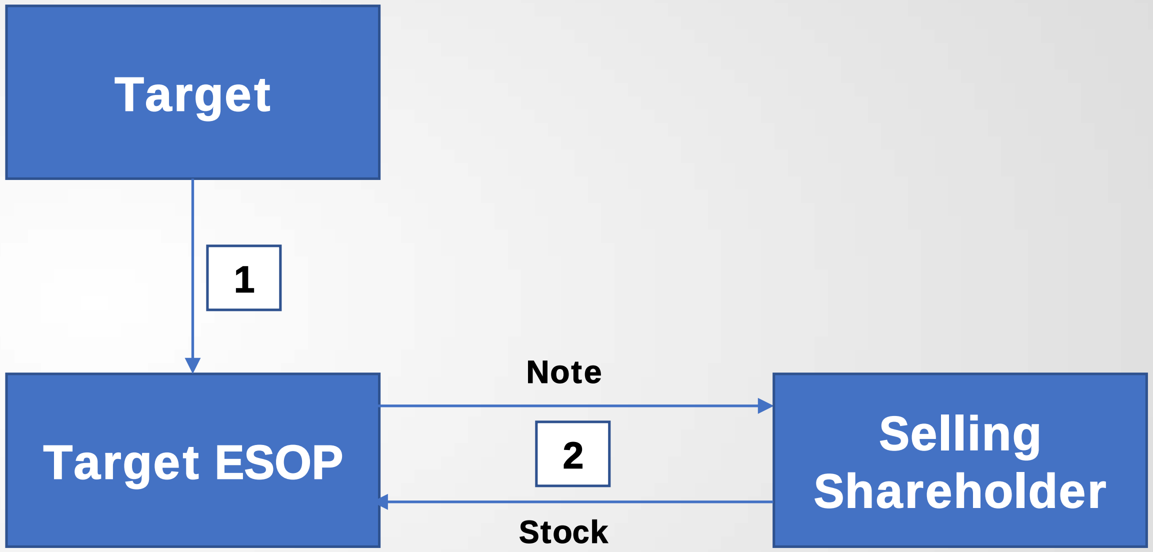
Overview of ESOP Acquisition Structure With 1042 Option for Target's Sellers

1. Target forms target ESOP
2. Selling shareholders sell stock to Target ESOP for a seller note
3. Acquirer forms Acquisition Subsidiary
4. Acquisition Subsidiary borrows cash from lenders or Acquirer
5. Acquisition Subsidiary lends loan proceeds to Target, which in turn lends the loan proceeds to Target ESOP
6. Target ESOP uses loan proceeds to repay the seller note to selling shareholders
7. Target ESOP merges into existing Acquirer ESOP
8. Target merges with Acquisition Subsidiary and ESOP receives Acquirer stock in exchange for Target stock



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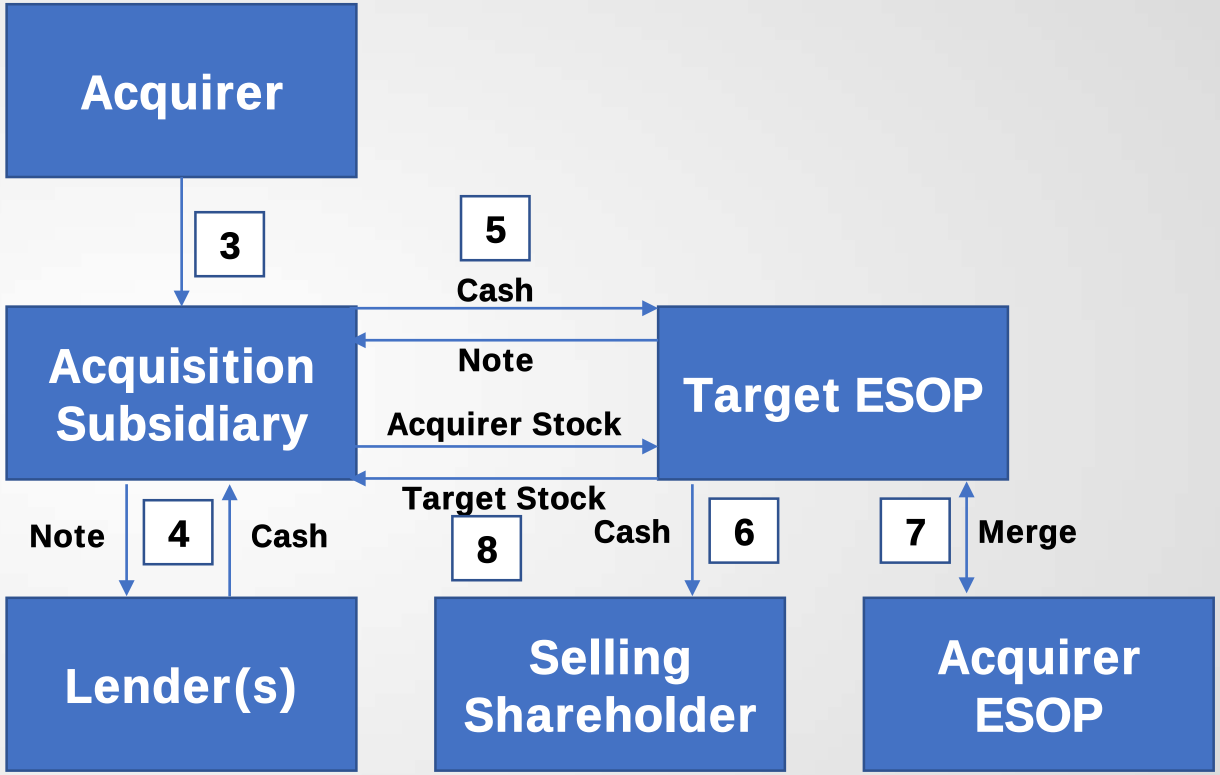

I.R.C. 1042 Eligibility for Seller(s)

- Target must be a C-Corp at the time of the transaction
- ESOP must own at least 30% of outstanding stock after the transaction
- Selling shareholders must have owned stock for 3 years
- Shares must not have been acquired through a tax qualified retirement plan, stock option plan, or other similar corporate plan

- Selling shareholders must reinvest proceeds in qualified replacement property (QRP) within a 15 month window
- QRP includes securities such as U.S. company stocks, U.S. company bonds, and floating rate notes but excludes municipal bonds, U.S. government bonds, mutual funds, foreign securities, and real estate / REITs
- 15 month window is from 3 months before the transaction to 12 months after the transaction

Illustrative Example of Tax Benefits to Seller

	Asset Sale	Stock Sale	1042 Sale
Sale Price	$50,000,000	$50,000,000	$50,000,000
Taxes Due – Corporate Level @ 26%	$13,000,000	$0	$0
Taxes Due – Individual Level @ 20%	$7,400,000	$10,000,000	$0
Net Sale Proceeds	$29,600,000	$40,000,000	$50,000,000

Note: This illustration assumes the target is a C-Corp with no cost basis in its assets (under the asset sale scenario) and no cost basis in it equity (under the stock sale scenario)

Merge Target ESOP Advantages and Disadvantages

Advantages

- Sellers receive all cash and the ability to make a 1042 election
- Avoids negotiations around a 338(h)(10) election
- Target employees become participants in acquirer ESOP, aligning corporate culture and employee incentives
- Sellers can participate in target management equity incentive plan (typically a SAR plan) if desired
- Sellers can preserve legacy with a transaction that ensures continuity of ownership and opportunity for employees

Disadvantages

- Complicated transaction with many moving parts
- Cost to implement may be higher

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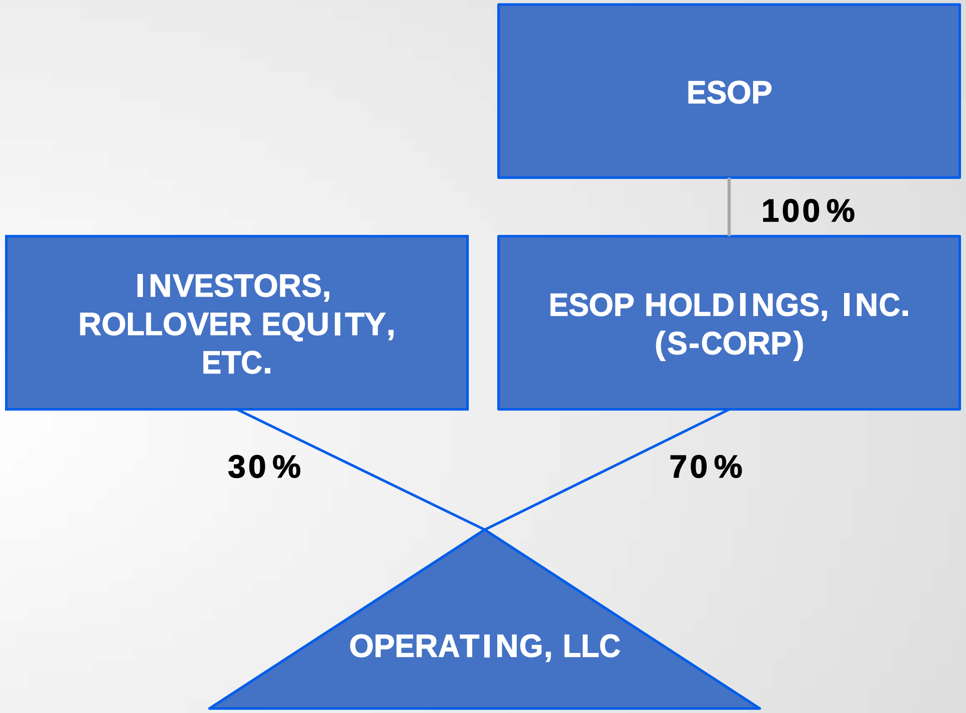
FINANCING ESOP COMPANY ACQUISITIONS: A STRUCTURING OVERVIEW

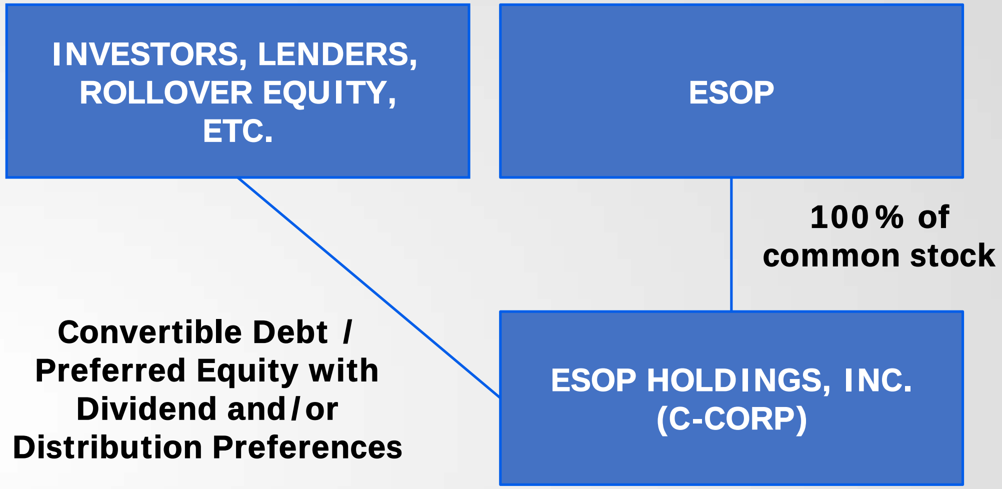
Financing Alternatives – Outside Equity Capital Through “Drop Down LLCs”

- By reorganizing the operating business as a LLC (taxed as a partnership), the S-Corp rules can be avoided allowing non S-Corp qualified shareholders to invest equity into the enterprise
- Distributions from the LLC need not be made pro rata by the partnership, preserving the “pass through” tax savings of the ESOP to be retained by the business to fund growth
- Segregation of the ESOP from the outside equity provider also eases investors’ concerns regarding liability under ERISA, making this structure a highly attractive opportunity



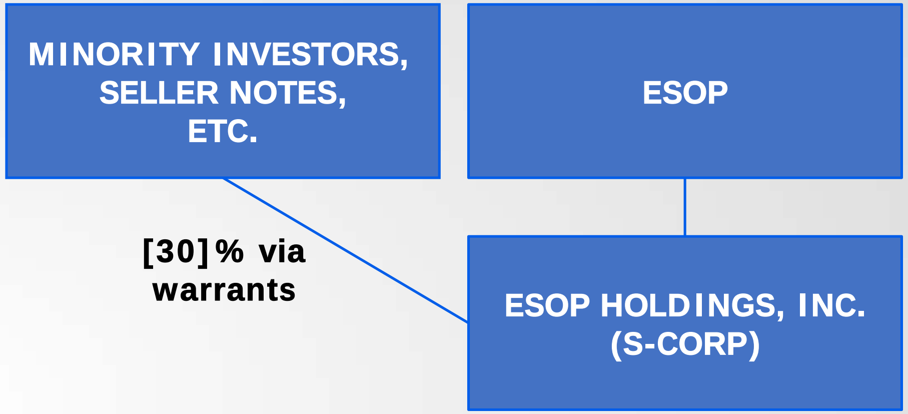
Financing Alternatives – Convertible Debt / Preferred Equity in C-Corps

- By maintaining C-Corp status, nonqualified S-Corp shareholders may still hold equity and/or equity-like instruments to gain access to additional capital
- Such capital providers are compensated through preferential returns (i.e., returns paid in a liquidation prior to proceeds paid out to common shareholders)
- Generally (but not always), C-Corp structures are temporary in nature, allowing tax planning to minimize “leakage” prior to the retirement of the preferred securities and a conversion to S-Corp status to regain tax efficiencies



Financing Alternatives – “Structured Equity” in S-Corps

- Similar to the preferred equity structure, investors can provide capital to the business through a debt security that provides consideration in the form of a reduced interest rate and warrants
- Contrary to the implied term, “structured equity” is a note (to comply with S-Corp shareholder restrictions and maintain tax efficiency), but its returns are driven by warrants, mimicking equity holdings
- “Structured equity” is a highly tax advantaged solution that allows for market competitive rates of return while enabling continued tax efficiency – a combination that drives high levels of interest among investors for these opportunities



Dawn Goestenkors

MBA, Executive Vice President, Employee Benefits Group
BS Finance, Quincy University, MBA Southern Illinois University – Edwardsville. Dawn brings vast experience and knowledge gained from more than 10 years in trustee services for employee stock ownership and qualified retirement plans. Dawn's past work experience includes commercial credit underwriting and lending. She has a concentration in plan administration and DOL regulatory issues, as well as deep ESOP transactional experience. Dawn is a member of The ESOP Association, Employee Owned S-Corporation of America (ESCA), National Center for Employee Ownership (NCEO) and frequently speaks on trustee and fiduciary topics. Dawn joined TI-TRUST in 2007.

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Ted Margarit

Ted is a member of Chartwell’s Corporate Finance practice, where he focuses on providing holistic ownership transition strategies, including the execution of ESOP transactions and/or traditional sell-side processes to strategic and private equity buyers.

Prior to Chartwell, Ted was an investment banker at Harris Williams & Company and Lazard Middle Market where he advised both family and private equity held companies on their sale.

Preceding his investment banking career, Ted practiced law in the areas of M&A and tax, with a particular emphasis on the creation, maintenance, and termination of ESOPs.

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Eric Zaiman

Eric Zaiman is an Executive Director in the ESOP (Employee Stock Ownership Plan) Advisory Group. He is dedicated to advising bankers and their clients on the benefits of executing ESOP transactions and understanding ESOP-related issues. Eric has a leadership role managing ESOP financing transactions, including evaluation, structuring, underwriting and execution.

Eric joined J.P. Morgan in 2009 with 21 years of experience in the finance industry. Prior to joining J.P. Morgan, Eric was with financial advisory firm Duff & Phelps for 11 years. Eric has structured ESOP transactions and raised financing for many companies and sellers. In addition, Eric has represented ESOP trustees, issuing transaction and valuation opinions. Eric began his career in banking, holding roles in relationship management and credit/risk management.

Eric received a Bachelor degree in Economics from the Yeshiva University and holds a Master of Business Administration in Finance and International Business from New York University. He is licensed by FINRA with a Series 79 and Series 63.

Eric is very active in the ESOP and finance communities and is a member of the ESOP Association (TEA), the National Center for Employee Ownership (NCEO), the Employee Owned S-Corporations of America (ESCA) and the Association for Corporate Growth. Eric serves on TEA's Valuation Advisory Committee, has previously served as an executive board member of TEA's New York/New Jersey Chapter and is a frequent speaker at national and regional conferences.

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