

Prepared exclusively for:

Exit Planning Institute Rocky Mountain Chapter

Employee Stock Ownership Plans (ESOPs)

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SES | ESOP
STRATEGIES

A STEVENS & LEE/GRIFFIN COMPANY 

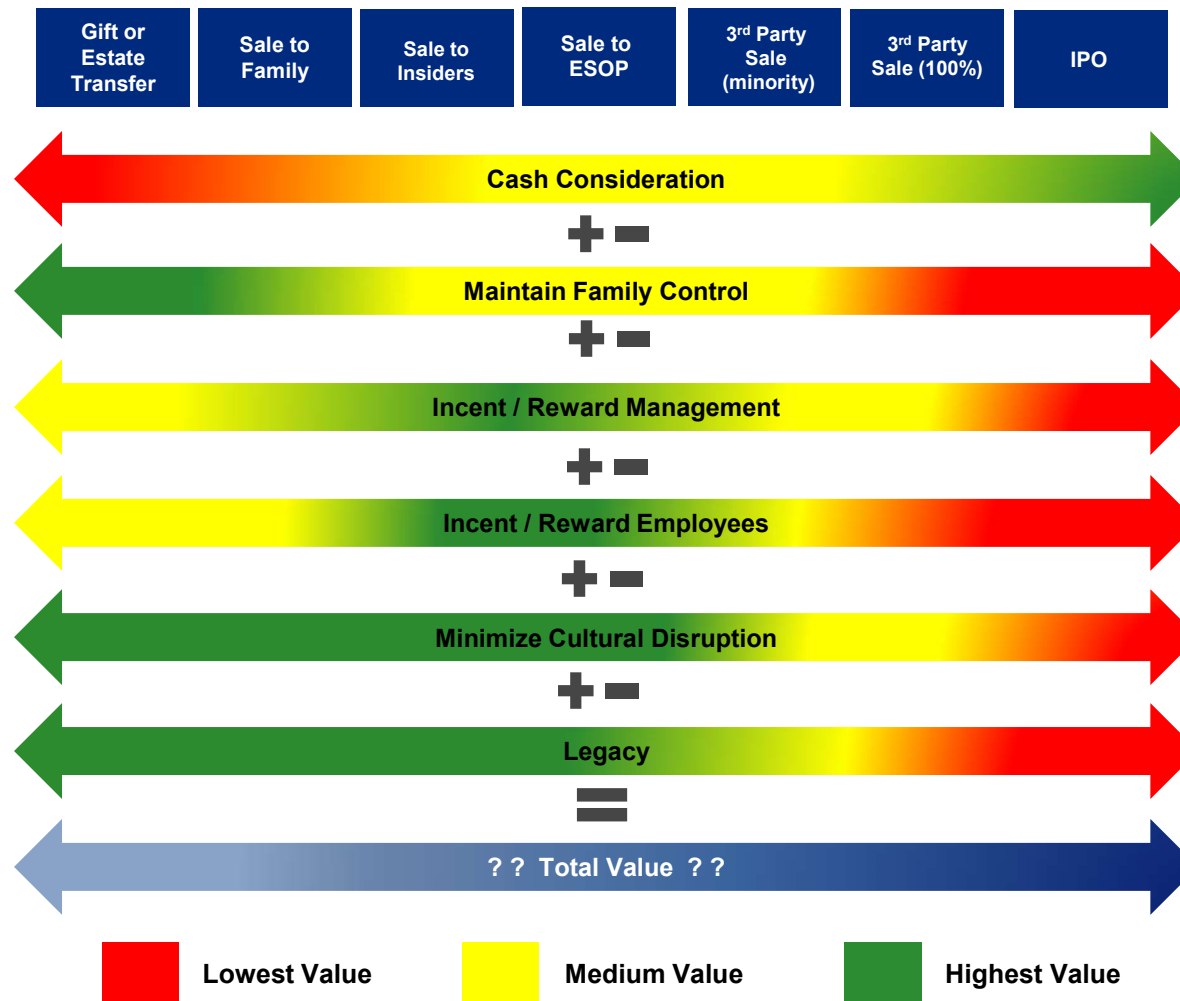
April 22, 2021

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I. Potential Strategic Alternatives

Ownership Transfer Options



II. Introduction – What is an ESOP?

What is an ESOP?

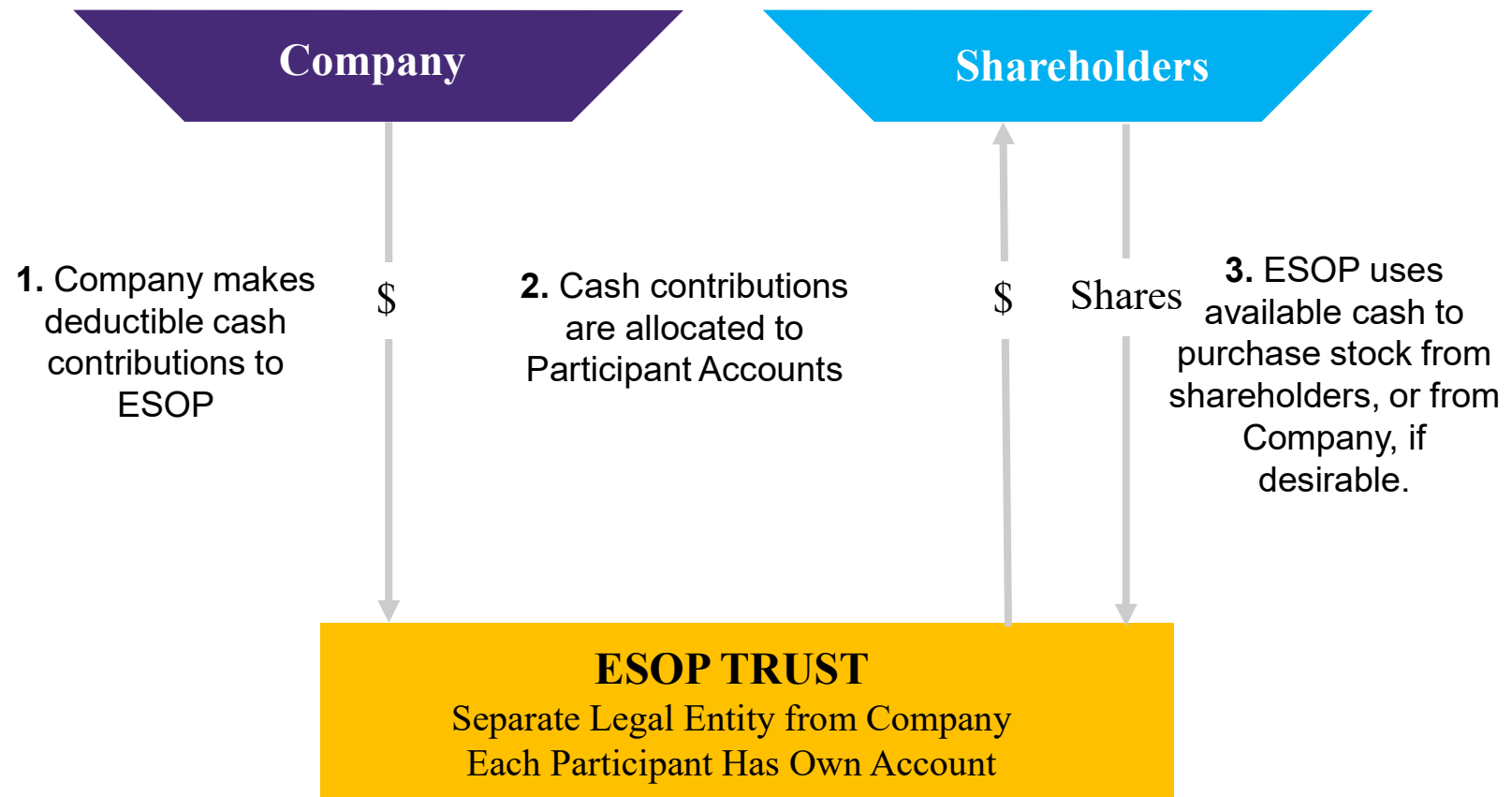
- Qualified retirement plan under IRS and ERISA
 - Regulated by US DOL and IRS
 - Defined Contribution Plan – typically no employee contributions
 - Assets held in a Trust – Employees do NOT own the stock directly
- Similar to other Profit Sharing Plans, but an ESOP can:
 - Borrow money
 - Engage in a transaction with a related party
 - And is intended to be invested primarily in company stock
- These 3 special attributes create a tax efficient and controlled means of selling stock

What an ESOP is not

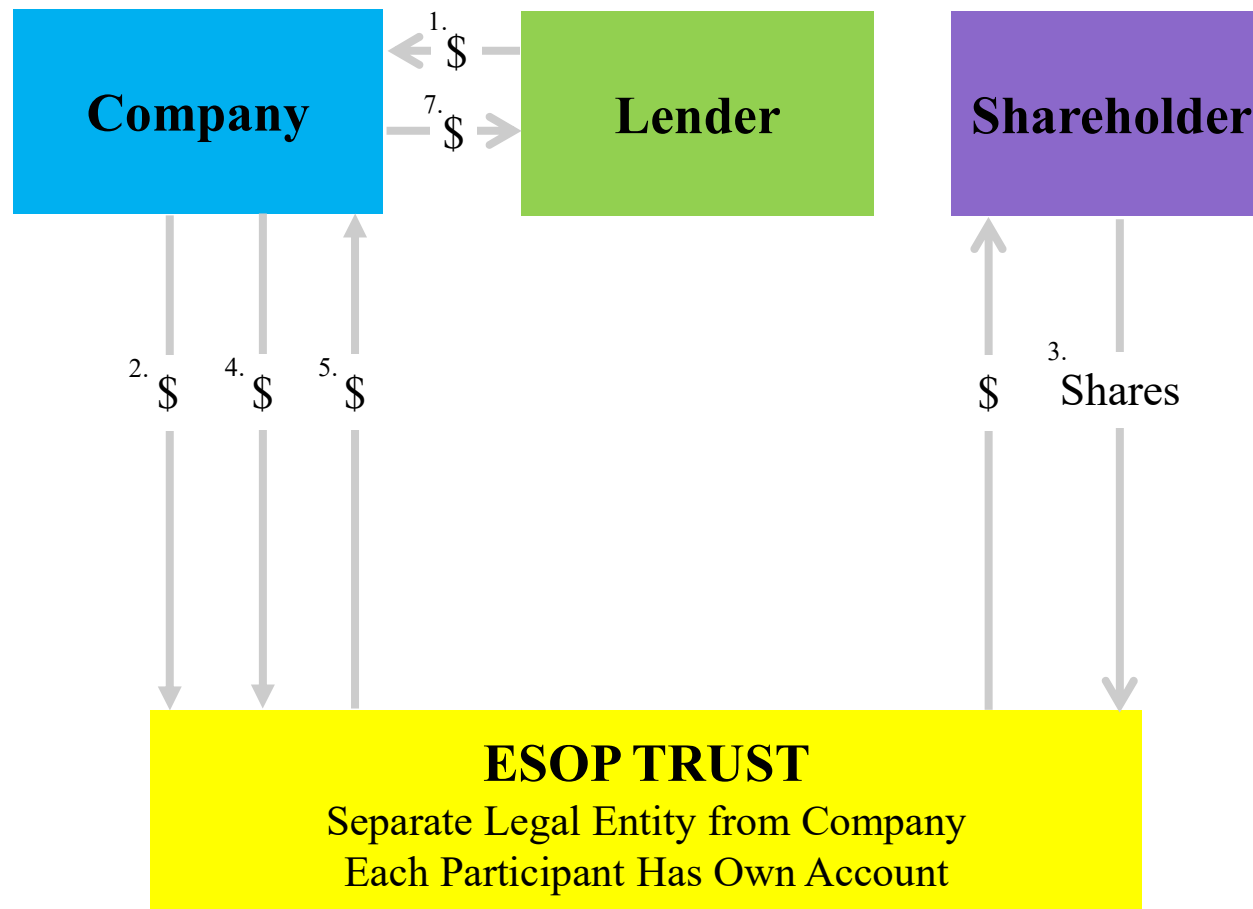
- Myth: **Owner is “giving” the Company to the employees**
 - **NO – ESOP trustee pays Fair Market Value for shares**
- Myth: **Employees can diligence Company books and records**
 - **NO – ESOP participants must receive annual statement showing value of their interest but detailed financial information is not required to be disclosed**
- Myth: **Owner will lose control of the Company**
 - **NO – ESOP transaction allows owner to retain control, potentially even in a majority or 100% sale**
 - **ESOP trustee votes for Board members and the Bod appoints management**
- Myth: **Significant Transaction/Maintenance Costs**
 - **NO – ESOP transaction costs are usually lower than selling to a 3rd party and are more than offset by tax savings**
 - **Annual maintenance costs limited to valuation, potential trustee and record keeping**

III. Mechanics of an ESOP

Mechanics of a Non-Leveraged ESOP



Mechanics of an ESOP Leveraged Buyout



1. Company borrows from Lender
2. ESOP borrows from Company
3. ESOP buys stock from shareholder (or newly issued shares)
4. Company makes fully deductible annual cash contribution to ESOP
5. ESOP makes loan payment to Company
6. Pro-rata shares are released from suspense account and allocated to Participant accounts
7. Company makes loan payment to Lender

ESOP Leveraged Buyout

PROS

- Tax efficient (for shareholders and for the Company)
- Flexible – transaction designed by shareholders
 - Percentage of stock sold
 - Timing
 - Different shareholders / sellers may be treated differently
 - Financing
 - Can be combined with other Management Incentive Plans
- Shareholder directed process

CONS

- Complex (though no more complex than typical M&A)
- Regulated
 - Terms must be “fair”
 - Broad-based employee benefit

IV. Tax Efficiency of an ESOP Leveraged Buyout

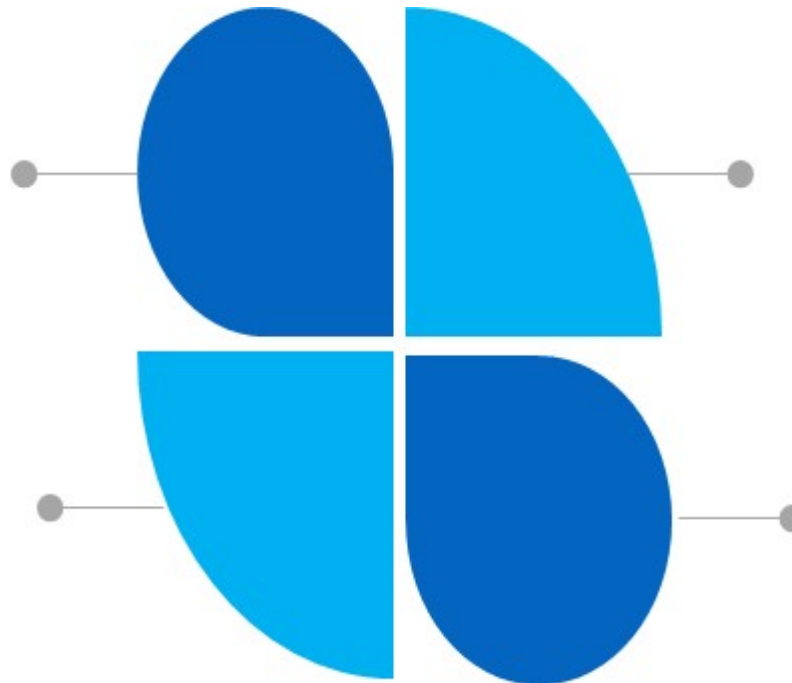
IRC § 1042 Rollover Requirements for Capital Gains Tax Deferral

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Seller(s) can elect to defer recognizing any gain on sale of stock, for federal (and most states) income tax purposes; handled properly, gain can be eliminated

Must be a C corporation at time of sale (can elect S-corp status after sale)

ESOP must own at least 30% of company immediately following transaction

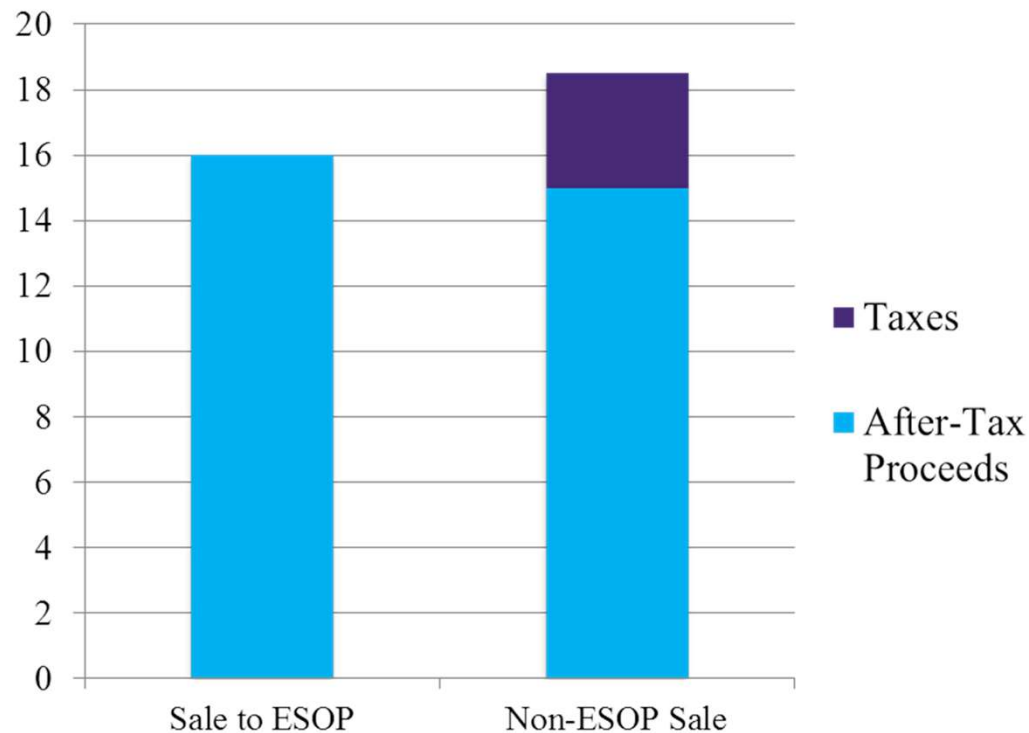


Seller must have minimum of 3-year holding period in company stock

Seller must reinvest proceeds of sale in Qualified Replacement Property (QRP)

Benefits and Risks to Selling Shareholder – 1042 Case Study

- 1042 Transaction: Mechanism for seller to defer capital gain from sale of stock



	Sale to ESOP	Non-ESOP Sale
Sale Price	\$16.0MM	\$18.5MM
Basis	\$4.0MM	\$4.0MM
Gain	\$12.0MM	\$14.5MM
Taxes*	--	\$3.5MM
After-Tax Proceeds	\$16.0MM	\$15.0MM
*Assumes 20% cap gains plus 3.8% Medicare surtax and holding replacement property until death		

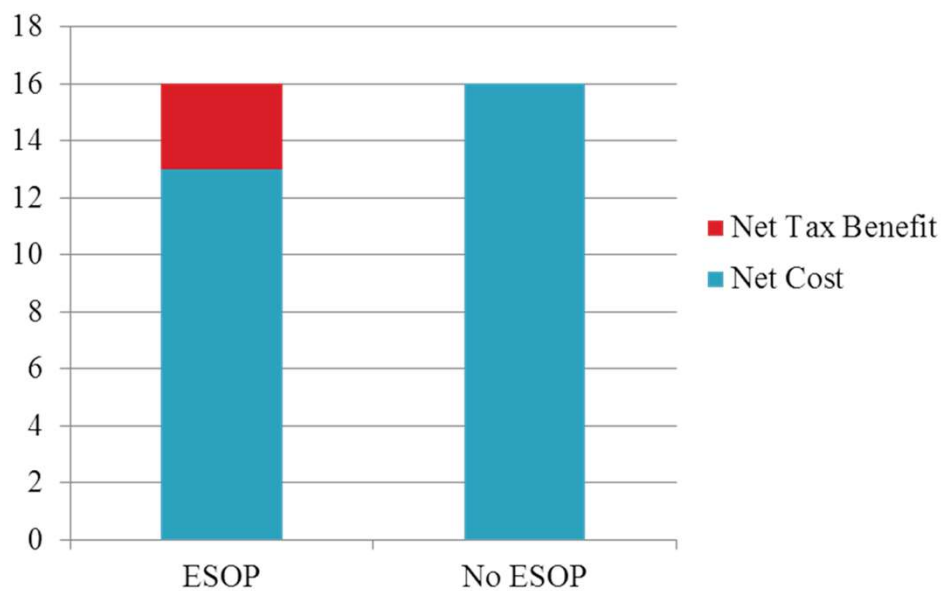
- Step-up Basis on Death =



Tax Benefits to the Company – Subchapter C Principal Deduction Case Study

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- Company can effectively deduct principal payments (ESOP expense)



	ESOP	No ESOP
Principal Borrowed	\$16.0MM	\$16.0MM
PV of Deduction for Principal Payments (over 10 years)*	- \$ 3.5MM	--
PV of Administration Costs (over 10 years)	+\$ 0.5MM	--
Effective Cost	\$13.0MM	\$16.0MM

* Assumes 29% effective federal and state tax rate

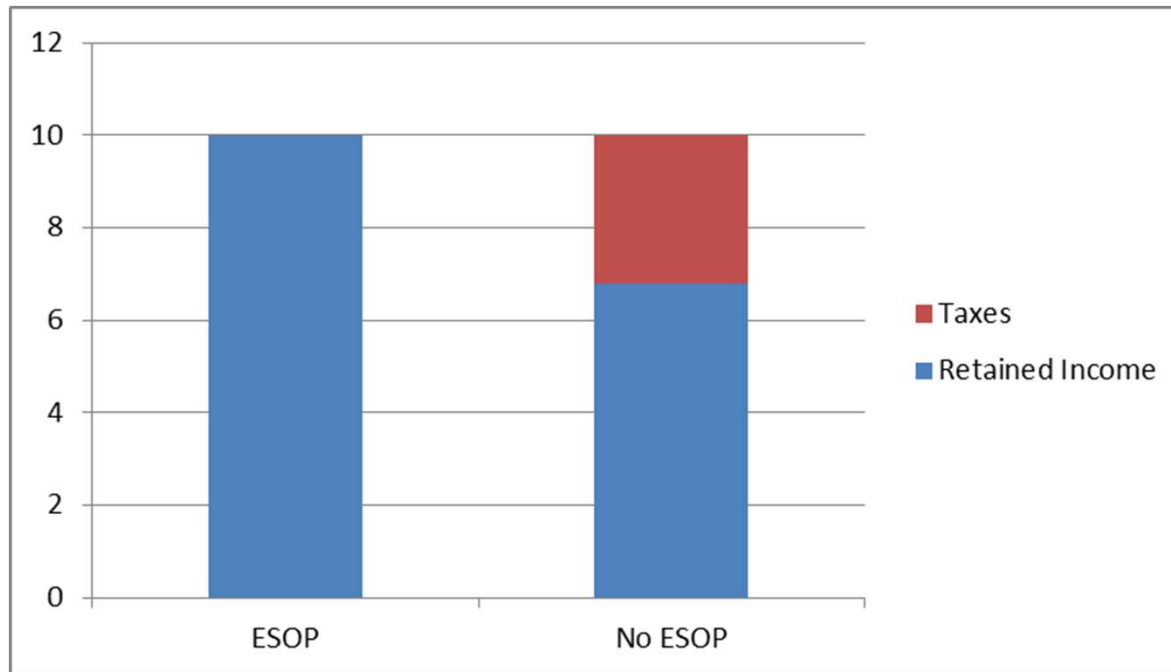
Note: Included in tax reform were limitations on the ability to deduct interest expense and first year expensing of some capital expenditures, etc. Although these changes are significant and important, from a relative basis most of these changes impact ESOPs in the same way as non-ESOP owned companies. ESOP owned companies may be able to effectively deduct more interest under the new rules than non-ESOP owned companies, but to be conservative, we did not include that benefit in this comparative analysis.

S Corporation ESOP Tax Benefits


- S corporation shareholders are responsible for paying income tax on their pro rata share of the Company's taxable income
- An ESOP, as a shareholder, is exempt from paying federal income taxes
- Thus, a 100% ESOP-owned S corporation operates completely federal (and, in most states) income tax-free
 - Doesn't have to be 100%; the percentage of ESOP ownership is tax-exempt

Benefits and Risks to the Company – S Corp Case Study

- 100% Tax Free Operation: S Corp owned solely by ESOP

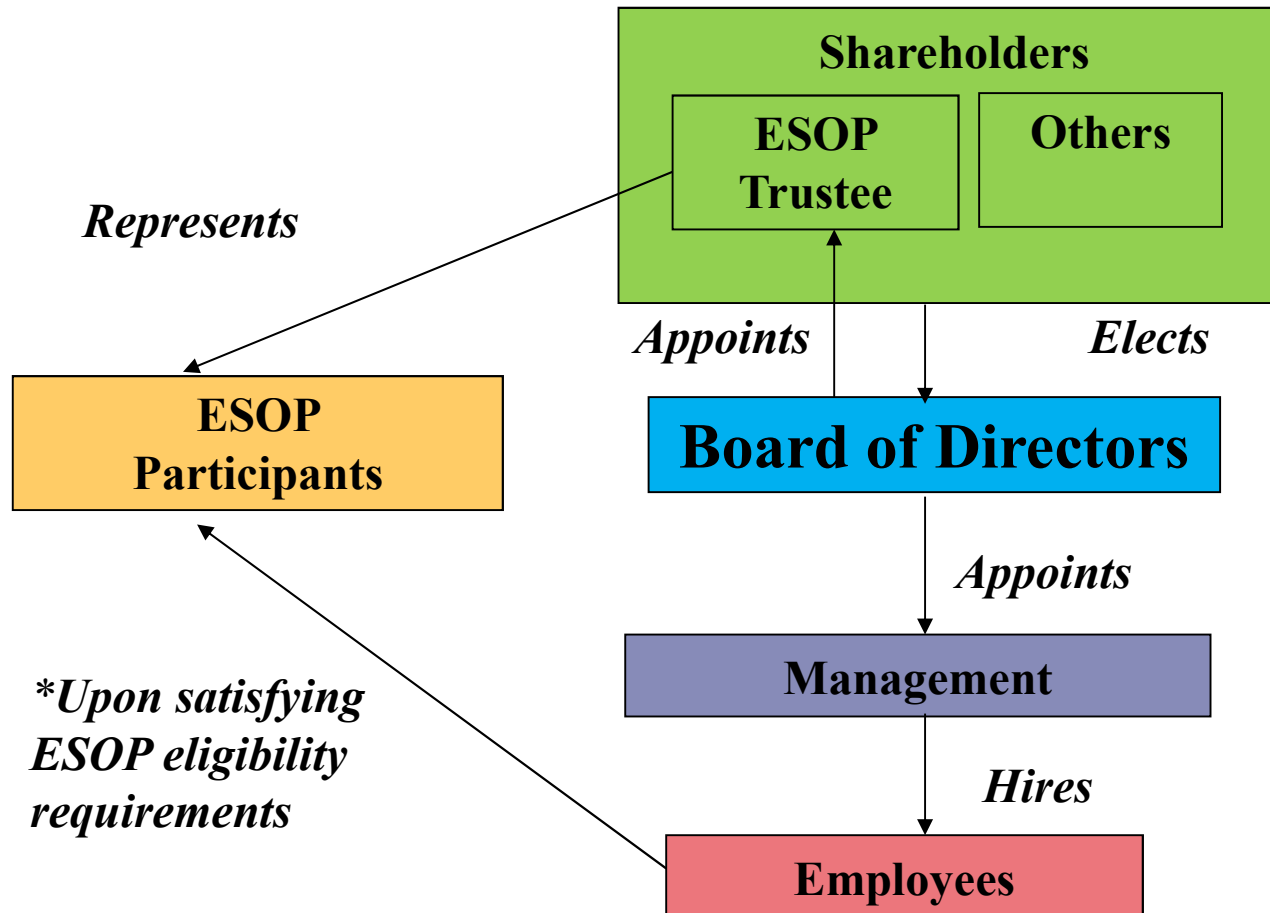


	ESOP	No ESOP
Net Income	\$10.0MM	\$10.0MM
Tax Liability*	--	\$3.2MM
Retained Income	\$10.0MM	\$6.8MM
*Assumes 32% effective federal and state tax		

- S Corp owned solely by ESOP =  Taxes
- Additional cash flow to support transaction debt

V. How an ESOP Company Operates

ESOP Company Structural Overview



ESOP Provisions



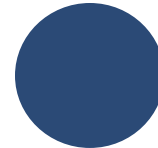
Allocation Formula

- Most common formula allocates contributions in proportion to eligible compensation (2021: \$290,000)



Vesting

- 3 year cliff or 6 year graded



Benefit Distribution Timing

- Permissible delays in distributions following termination of service; five installments

ESOP Stock Appraisals

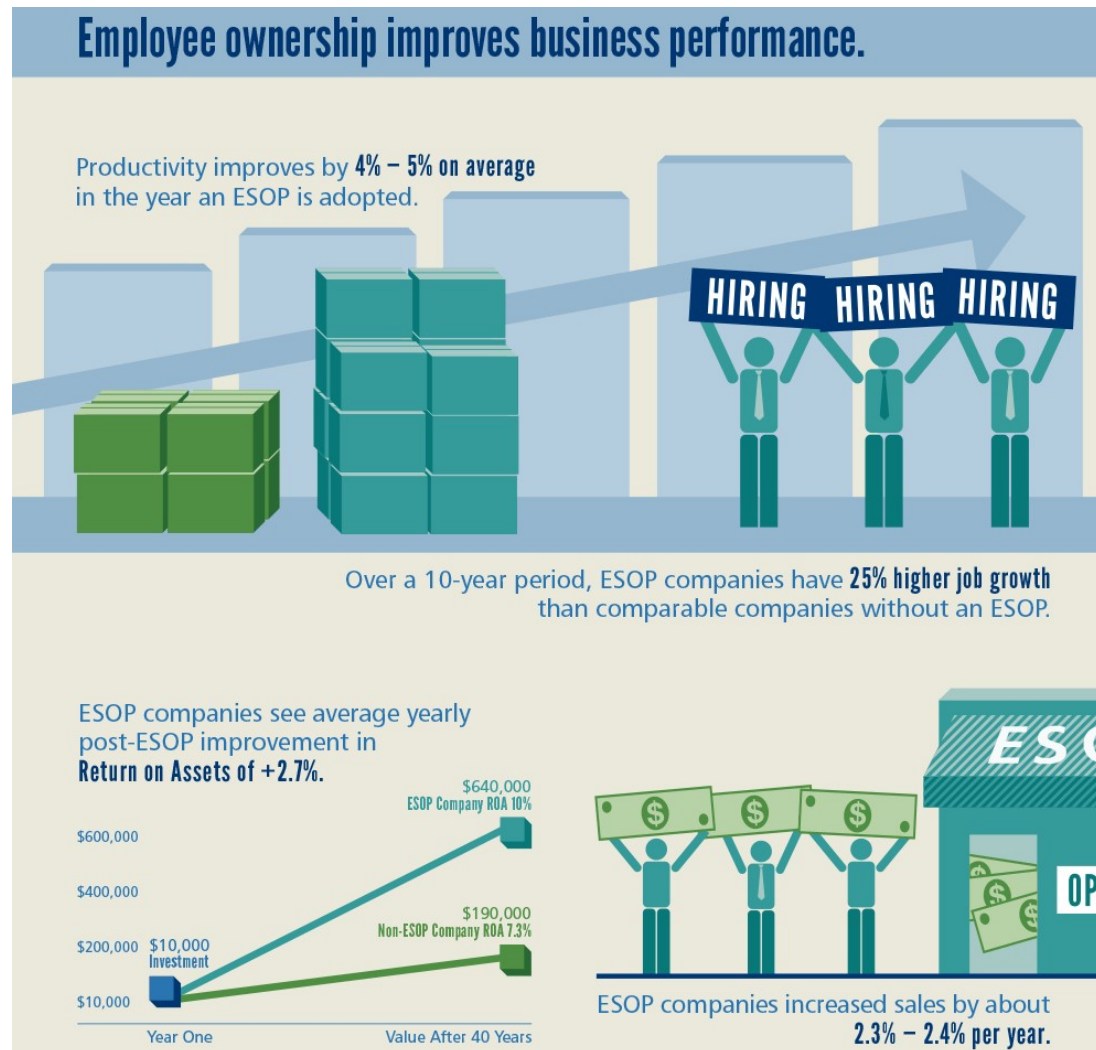
- ESOP Trustee hires a third-party, independent appraiser as an advisor
 - Fairness opinion for transaction
- Appraiser should be experienced in valuing stock for ESOP transaction purposes
- ESOP stock must be reappraised annually
- “Fair Market Value”

General Requirements and Considerations

- Must plan for and fund future repurchases of stock from employees, which depending on demographics can be significant
- Accounting is complex and can be counterintuitive
 - Can be mismatch between compensation expense and contribution deduction
 - Shares held in suspense create contra-equity account and are not considered outstanding for EPS purposes
- Voting – pass-through to participants
 - If private, participants can direct Trustee on voting for matters involving merger, consolidation, recapitalization, reclassification, liquidation, dissolution, or a sale of substantially all assets. No right to vote in any other matters
 - If public, participants can direct Trustee on all matters
- Diversification – participant can elect to diversify
 - If private, after age 55 and 10 years of service
 - If public, after 3 years of service

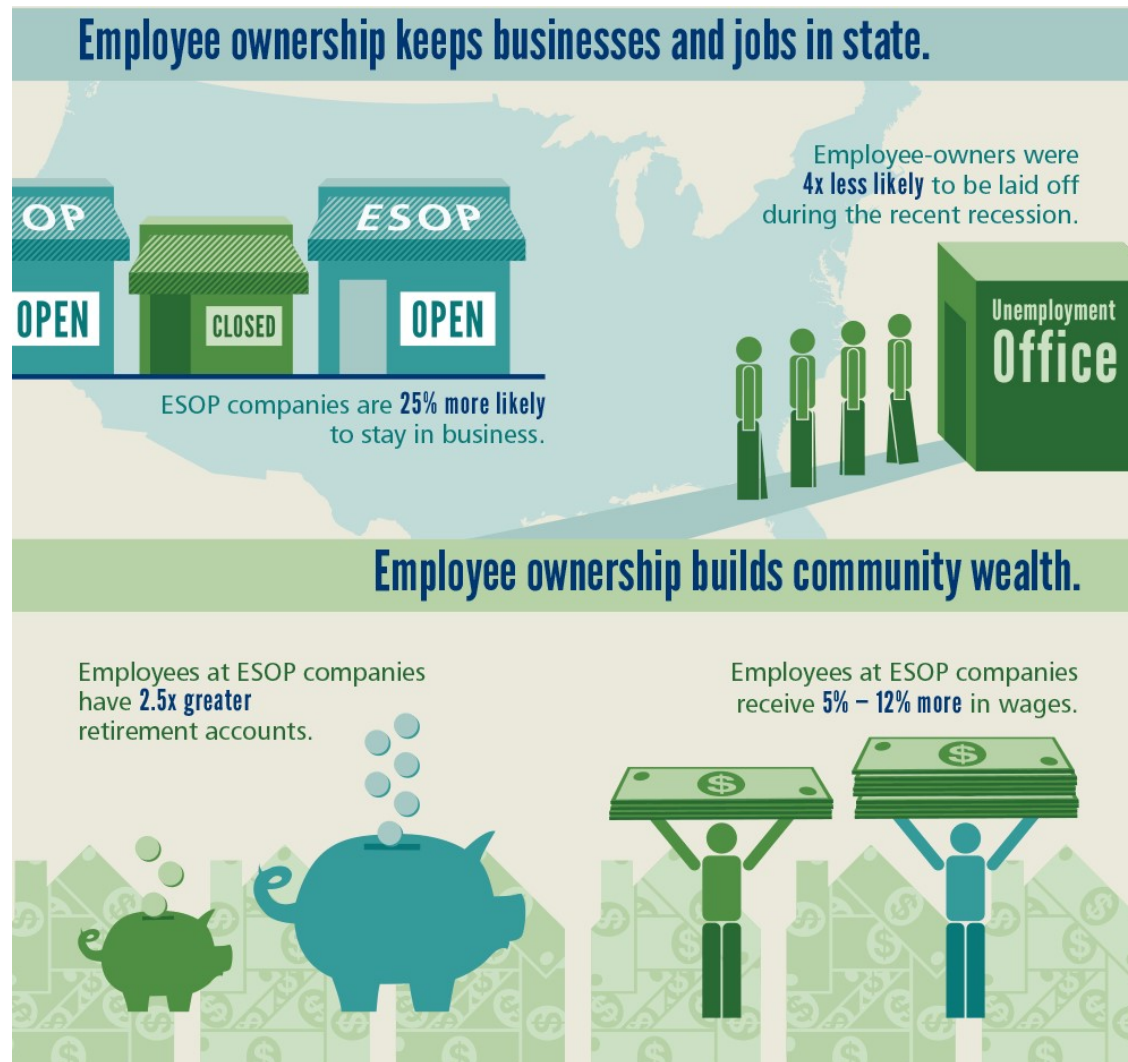
VI. The Benefits of Employee Ownership

Benefits to the Company



Infographic by National Center for Employee Ownership (NCEO) from [The Economic Power of Employee Ownership](#)

Benefits to Employees



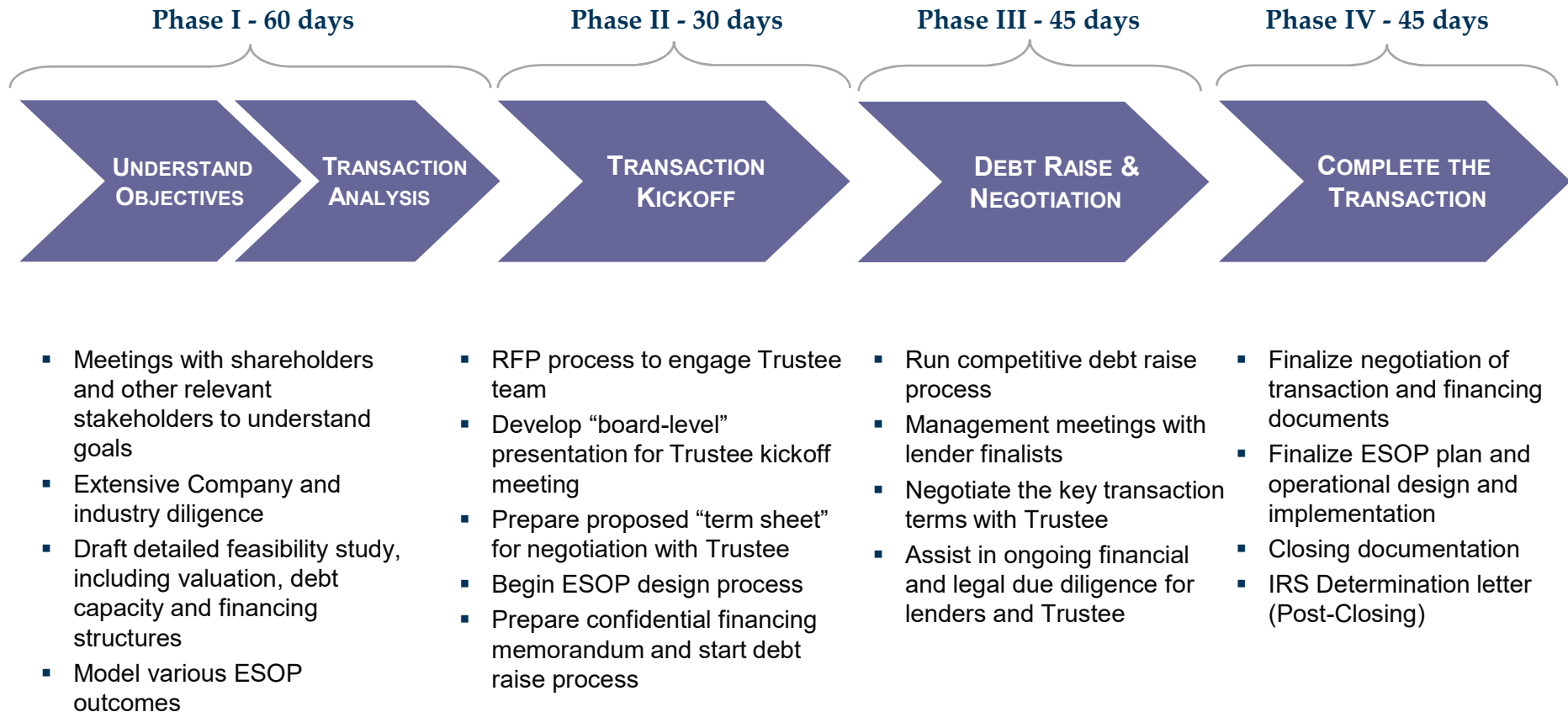
Infographic by National Center for Employee Ownership (NCEO) from [The Economic Power of Employee Ownership](#)

VII. Ideal ESOP Candidates and Transaction Timeline

Ideal ESOP Candidates

- Three Key Considerations
 - Minimum Employees: 20-25 (maybe smaller with C Corp)
 - Profitable
 - Need cash flow to support transaction debt
 - Transaction of \$2MM or more
 - Minimum size needed to justify professional fees
- ESOPs are a viable ownership transition strategy for the vast majority of privately-held companies and provide flexibility that 3rd party sale transactions typically do not accommodate
 - Minority transaction (staged exit)
 - Retention of control
 - “Friendly” buyer

Transaction Process and Timeframe



INITIAL ENGAGEMENT

180 DAYS

CLOSING

VIII. Overview of SES ESOP Strategies

SES ESOP Strategies

- Together with its affiliated companies, SES ESOP Strategies brings together one of the largest core groups of ESOP lawyers, consultants and investment bankers in the U.S.
- Our depth and breadth of experience set us apart from other ESOP consulting firms. During our three decades of experience, we have implemented ESOPs for more than 500 companies and have completed more than 1,000 ESOP-related transactions
- Our multidisciplinary team provides comprehensive services and support to guide companies through the design, implementation and ultimately, the maintenance of a successful ESOP
- If desired, we can help raise the debt necessary to fund the transaction and all or a portion of the company's future working capital and other needs
- National ESOP practice with professionals in Pennsylvania, Florida, New York, Ohio, Texas, New Jersey, Massachusetts and Colorado
- SES ESOP Strategies is a boutique practice within Stevens & Lee/Griffin, a multidisciplinary professional services platform

Presenter Biographies

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EXPERIENCE

- Advises companies, owners and other stakeholders on M&A and private capital raise transactions, with a particular focus on ESOP ownership transactions
- Brings a breadth of experience as a former board member, business leader, investor and advisor for a wide range of ESOP-owned businesses
- Former Chairman and CEO of Alliance Holdings, Inc., an ESOP-owned holding company, where he delivered positive economic results, implemented a new corporate governance structure and drove growth through acquisitions
- After being promoted to Chairman and CEO of Alliance, Ken successfully led the efforts to protect ESOP participants and ensure the viability of Alliance by settling outstanding ERISA litigation against the company and recovering substantial damages from multiple involved parties
- Founding member of the ESOP corporate finance group in the investment banking group of Houlihan Lokey, where he advised on some of the largest and most innovative employee buyouts in history
- Education: Duke University, the Fuqua School of Business, MBA, and the University of Michigan, B.S., Aerospace Engineering

Presenter Biographies

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EXPERIENCE

- Concentrates his practice in helping companies navigate the complexities of employee stock ownership plans (ESOPs) and advises business owners on how to sell their companies to employees through an ESOP
- Also advises on other ESOP-related transactions, including situations where ESOP-owned companies sell to outside buyers when they have determined that exiting the ESOP structure is appropriate for shareholders
- Works with the entire range of ESOP-owned companies, including S Corporations, C Corporations, private companies, publicly traded companies, companies that are wholly owned by the ESOP trust and companies in which the ESOP is a minority owner
- Counsels ESOP trustees on their fiduciary obligations under ERISA in ESOP-related transactions and when unique situations arise in an already established ESOP
- Also has particular experience working with ESOPs for financial institutions, such as community banks looking to an ESOP as a source of liquidity for founding shareholders and insurance companies who establish an ESOP in conjunction with a demutualization
- Education: Georgetown University Law Center, J.D., *magna cum laude*, Order of the Coif, and The Catholic University of America, B.A., First in Class, *summa cum laude*, Phi Beta Kappa

Presenter Biographies

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EXPERIENCE

- Parrish has been with Marx|Okubo for more than 20 years and is currently President/CEO
- Has over 25 years of experience in management and commercial real estate, including contract negotiations, asset management, redevelopment/development and brokerage, involving over 10 million square feet of commercial space and 30,000 multifamily units
- Previously, Parrish served as an executive with a national multifamily firm and for an institutional real estate investor. He is proficient in the economic analysis of all commercial and multifamily property types and real estate ventures, including sensitivity, redevelopment analysis, loan modifications, operating strategies and distressed work-out situations
- Parrish holds a bachelor's degree in environmental design from Texas A&M University and an MBA with an emphasis in real estate finance from Southern Methodist University. He is a licensed real estate broker in Texas and Colorado as well as a member of the Urban Land Institute and National Association of Industrial and Office Properties

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