ESOPs: Pros, Cons & Important Comparisons

FIRST, LET'S COMPARE SOME COMMON LIQUIDITY STRATEGIES.

	Leveraged Dividend	Internal Sale	Third-Party Sale	Leveraged ESOP
OVERVIEW	Company secures financing to pay shareholders a special dividend	Family or staff purchase stock from a current shareholder	Acquisition by strategic or private equity buyer	Sale to employee trust, financed with 3rd party and/or seller debt
CORPORATE IMPLICATIONS	Financing may strain capital structure and reduce cash flow	Management must be transition-ready; transaction financing may be necessary	Outside investor will likely take complete control of company	Company earns tax incentives and board maintains oversight
SHAREHOLDER RETURN	Single, taxable payment often equivalent to 10-30% of the company's value	Liquidity, likely at a discounted valuation, and subject to capital gains taxes	Full equity monetization, subject to capital gains taxes and a potential earn-out	Fair market value for equity; capital gains taxes can be deferred and/or eliminated
THE UPSHOT	**Modest shareholder liquidity event with relative financing risk**	**Succession opportunity, but with notable tax-inefficiencies for buyers and sellers**	**Taxable exit with little to no upside and minimal say in company's future**	**Tax-advantaged liquidity event with upside & legacy preservation**

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THE PROS & CONS OF LEVERAGED ESOPs

SELLERS PAID FAIR MARKET VALUE (FMV)

FMV is derived through an independent valuation, followed by negotiations between a plan's sponsor and an ESOP trustee. Both sides must agree on a price to consummate a transaction

ESOP CANNOT OFFER MORE THAN FMV

Although an ESOP's tax incentives can help close or eliminate a potential gap in after-tax sale proceeds, there are occasions when a strategic sale will be the most financially advantageous option.

AN EMPLOYEE TRUST IS A KNOWN BUYER

M&A due diligence may expose sensitive corporate data to competitors. Although an ESOP sale is also subject to a rigorous fact-finding process, an employee trust ultimately has the company's best interest in mind.

HIGHLY STRUCTURED TRANSACTION

ESOPs are regulated by the US Department of Labor, with formal rules codified by the IRS. As a result, employee ownership transactions feature complexities that aren't often encountered in typical M&A deals.

NON-RECOURSE FINANCING IS AVAILABLE

Senior debt, offered without personal guarantees, can often finance a sizable portion of a leveraged ESOP transaction. Employee-owned companies repay these loans with pre-tax corporate cash.

PARTIAL SELLER FINANCING IS COMMON

Although third-party ESOP lenders are plentiful, most transactions include a seller note component. The extent of seller financing often depends on a company's fundamentals and industry.

TAX BENEFITS, UPSIDE & INDEPENDENCE

All stakeholders are entitled to tax incentives and can tangibly benefit when the company prospers. Post-transaction, the firm's board maintains leadership, while sellers often keep salaries and hold meaningful roles.

ONGOING MAINTENANCE IS REQUIRED

Plan sponsors are required to run annual, independent valuations and submit an IRS Form 5500. A third-party administrator manages day-to-day oversight, statements, vesting schedules, and share repurchases.

READY TO LEARN MORE? LET'S CONNECT.

CSG PARTNERS

Recognized as the nation's premier ESOP advisor, CSG has completed hundreds of transactions for middle market companies nationwide.

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