INDEPTH

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REPRINTED FROM:
AUGUST 2010 ISSUE

FW MAGAZINE

FINANCIER WORLDWIDE corporatefinanceintelligence

PRIVATE EQUITY

The role of ESOPs in private equity deals

BY MUAZZIN MEHRBAN

A well structured Employee Stock Ownership Plan (ESOP) can, subject to certain limits, provide companies with a reduced tax burden, leaving more cash available to repay transactional debt and fund future growth. Further to these tax benefits, by giving employees company ownership, boards can boost a target company's financial success, as ESOPs can help to incentivise dedicated members of staff. As beneficial owners of the company, employees are driven to improve the value of their own stake and hence company value overall. Given that employee rights to shares held in the ESOP are vested over time, such a plan can also reduce employee turnover and retain existing talent.

According to some experts, substantial benefits can be derived from an ESOP by making the plan part of a strategy to offset a target's benefit pension cost. Firms that utilise this opportunity, which combines the best attributes of an ESOP and a benefit pension plan, will then have additional capital to execute the transaction itself. This improves the portfolio company's cash flow and, most crucially, reduces its pensions risk exposure. Such structures can also be designed in a way that prevents them interfering with corporate governance issues crucial to the private equity style of management. "Historically, most PE firms have not utilised ESOPs at portfolio companies in a buy situation," explains John Vitucci, president Pension Equity Advisors, LLC. "The reasons vary. Some portfolio companies were not significant taxpayers given their debt load and any potential ESOP tax benefits were of no incremental value. In addition, PE in the past could easily raise capital and some may have had a bad experience, where an ESOP generated a lawsuit, or caused some kind of delay in entering or exiting a transaction. However, this perception is changing and may change further over the next few years if the leverage challenge continues and tax rates and rules continue to change." Mr Vitucci gives the example of the potential end of tax cuts in the US, along with the 'carried interest' paid to PE being under scrutiny, acting as a potential trigger for more creative deal structures, including ESOPs. A long-term shift towards an investor model similar to that of Berkshire Hathaway, the investment vehicle owned by Warren Buffett, would see ESOPs used more frequently to attain long-term returns.

Structural considerations

When implementing an ESOP, costs, cash flow, corporate governance and the speed with which the transaction can be completed, are all issues that must be taken into consideration. If a PE firm's goal is a very short-term investment and return, with a quick exit strategy, then an ESOP may not be the best option. But for firms looking to create long-term value and align the needs of a business and its staff, incorporating an ESOP can prove highly beneficial. Fully understanding the risks and benefits of an ESOP is essential to determining whether it is the best course of action.

There are some key considerations to make when structuring an ESOP. First, due to the financial complexities, a firm should ensure that decisions are made by qualified trustees. ESOP trustees should have exclusive authority and discretion over the administration, management and control of ESOP plan assets – including corporate stock – insists Steven Burke, a partner at McLane, Graf, Raulerson & Middleton. "The trustees have fiduciary obligations of loyalty and prudence to ESOP participants and beneficiaries. An ESOP trustee can be a company 'insider' or a third party. A PE firm should ensure that at least one trustee of the ESOP is an 'insider' knowledgeable on company operations. To ensure appropriate administration of an ESOP, it is helpful if at least one trustee has experience dealing with pension plans in particular," he says. He also highlights the importance of vesting provisions, as they affect both employee retention and company cash flow.

Indeed, once an employee has vested interest through an ESOP account, he or she then has a non-forfeitable right to the ESOP account balance. In terms of the vesting itself, there are essentially two types: cliff vesting and graded vesting. Graded vesting means an employee's right to accrued benefits becomes non-forfeitable over time, while cliff vesting means they become non-forfeitable all at once after a certain period of time. If a member of staff leaves a company prior to expiration of a cliff vesting period, then the employee forfeits 100 percent of his or her rights to ESOP benefits. Hence, in order to obtain maximum benefits, employees are incentivised to stay on throughout the vesting period.

Control remains an important factor for PE firms entering ESOPs. In fact, some PE firms have been known to avoid ESOPs due to the mistaken belief that majority stock ownership by an ESOP means that the company is controlled by the ESOP or its employees. However, Tim Jochim, a partner at Kegler Brown Hill & Ritter, explains that control of a company owned by its ESOP is unrelated to ownership, which itself is determined by the language in the bylaws of the company and by the ESOP documentation itself. "Another important factor for a PE firm is relative return. The trustee of the ESOP, as the legal owner of the stock in the ESOP, has a legal obligation to negotiate a return for the ESOP that is financially fair relative to the return for other investors. A fair return for the ESOP does not require the highest return nor a return equal to the return of the PE firm, but it may require a priority return to meet certain benchmarks, such as the cost of equity or market guideline returns." In any case, PE firms should be using their superior expertise in financial modelling to get the most out of an ESOP structure.

As with any deal, advanced planning and fi-

nancial modelling are essential for a successful ESOP. Failure to prepare adequately can hurt the business three or four years down the line. Janet Thomas, a partner at Hirschler Fleischer, says that many firms simply fail to realise the full benefits of an ESOP as a corporate tool. "Any analysis should include a study of future compliance with the necessary benefits tests applicable to tax-qualified retirement plans given the projected deal terms. This requires a close study of the ESOP loan amortisation schedule. The modelling should also include a review of the ESOP loan amortisation for consistency with desired benefit levels for the company," she says. "Since the annual release of stock to the ESOP, and hence the level of employee benefits, is tied to payments on the ESOP loan, repayment on that loan drives benefit levels. Modelling should include solid projections of repurchase obligations arising from the payment of benefits under the plan, including design alternatives concerning the manner, lump sum or instalment, and timing of benefit payments." As executives have access to traditional equity interests in ESOP companies, proper incentives must be built using other methods such as synthetic equity plans. Structuring executive compensation may require complex financial modelling, particularly where complicated tax rules are involved.

ESOPs and pensions

ESOPs can be used in combination with a 401(k) plan, allowing a company to free up cash for working capital and investment. It has also enabled employees to indirectly purchase stock in the company, which is not an option with a standalone ESOP. "To protect employee pensions if the company fails, the ESOP should provide liberal diversification provisions. ESOPs are required to provide employees who have reached the age 55 and have 10 years of plan participation the right to diversify up to 25 percent of the employer stock in their accounts that year for five years thereafter," explains Mr Burke. He adds that the diversification percentage will increase to 50 percent when an employee reaches the age of 60 and has given 10 years of service. "ESOPs can expand this diversification or payment right by permitting diversification at a younger age and/or upon fewer years of ESOP participation in order to protect participants from fluctuations in the value of the company's stock. If the corporation has a separate 401(k) plan, the ESOP can also permit diversification by allowing participants to transfer the value of corporation stock from the ESOP to the 401(k) plan."

Firms are advised to consider a 'hybrid' design combining the best attributes of an ESOP and a pension benefit scheme. "Employee participants in floor-offset designs can obtain the benefits of employee ownership including both financial upsides and technology advances with downside protection through a guaranteed pension," says Mr Vitucci. "The floor-offset design maintains an overall pension foundation while allowing a maximum of 10 percent investment of pension funds in employer securities. Besides providing better protections for workers, the floor offset with an ESOP can help PE in raising capital to help execute a transaction and can help with the ongoing defined benefit pension funding requirements going forward." It is important for companies to offer alternative retirement benefits through a 401(k), profit sharing, or a defined benefit pension. As such, it may be necessary to educate employees on the benefits of an ESOP scheme, according to Michael Keeling, president of the ESOP Association. "If the company leaders believe in the ESOP structure, they believe in the ability of average pay employees to understand, and to heed, information about diversification. An ESOP company can also exclude company stock from their 401(k) plan, include liquid assets in the ESOP in addition to company stock, and encourage older, longer-term employees to shift some of the company stock in their ESOP account into other assets, particularly if a sizeable ESOP account has accrued to the employee."

Disadvantages for employees

Employees of an ESOP company tend to face lower pension risk than those of non-ESOP companies. Studies comparing ESOP and non-ESOP companies reveal that the former outperform the latter in the long term, especially in terms of profitability and employment growth. However, Ms Thomas warns that employees could have frustrated expectations, since stock ownership through an ESOP is not the same as direct ownership. "Specifically, participants are only required by law to be allowed to vote on certain actions with respect to the stock in their accounts, such as a sale of substantially all of the assets or a merger. By contrast, participants are not entitled to vote on a sale of the company stock held in plan accounts. The trustee of the ESOP votes the shares in that instance. In the case of a sale of stock, the trustee's duty is to vote in the best interests of the plan as a retirement asset for all participants – both current and former employees." Furthermore, Ms Thomas adds that a trustee, as part of his or her role, should not consider the job security of current employees a factor when voting. This is something an employee may of course do if allowed to vote directly.

When structured properly and with the right intentions, private equity deals using ESOPs can be very successful compared to similar deals where ESOPs are absent. In order to increase value and deliver returns, firms should look at combining an ESOP with other benefit plans, providing greater employee investment diversification opportunities and reducing participant risk. Also, regularly updating ESOP participants on company performance and providing them with constructive opportunities to share ideas about how to improve company performance would incentivise staff to become more productive and drive up the value of company stock. However, Mr Jochim points out that some PE deals based on ESOP schemes have proven to be less successful than the traditional model. "PE firms tend not to be patient long-term investors," he notes. "Warren Buffett would be an ideal ESOP trustee because he is a prudent and patient long-term investor in lines of business that he understands and in management teams that he trusts. By comparison, many PE firms tend to leverage returns on equity through high levels of debt and then exit the company after three to nine years. In both Warren Buffett companies and in good ESOP companies, management is rewarded in direct proportion to long-term increases in shareholder value, while in many PE dominated companies, management incentives are tied to returns on the next transaction or recapitalisation."

However, if a PE firm fully embraces the concept and structure of an ESOP, and takes time to perform financial modelling prior to a deal being transacted, such a strategy can prove successful and give the portfolio company a competitive advantage in the market place. Firms should ensure they are well versed in the laws governing ESOPs, which are highly specialised, as this will allow them to be more aware of not only the benefits associated with such a structure but also the pitfalls. Indeed, firms that do so are more likely to fully appreciate the benefits of an ESOP, particularly the potential for tax-free earnings and for increased employee productivity. ■

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