# Vermont Employee Ownership Center

## Sixth Annual Employee Ownership Conference

# Financing an ESOP

Burlington, VT

June 6, 2008

# Program Agenda

- Basic Leveraged ESOP Structure
- Types of Money
- Financing a <100% ESOP
- Financing a 100% ESOP
- Second Stage ESOP Financing
- Banking Market Today
- Preparing For Your Bank Meeting

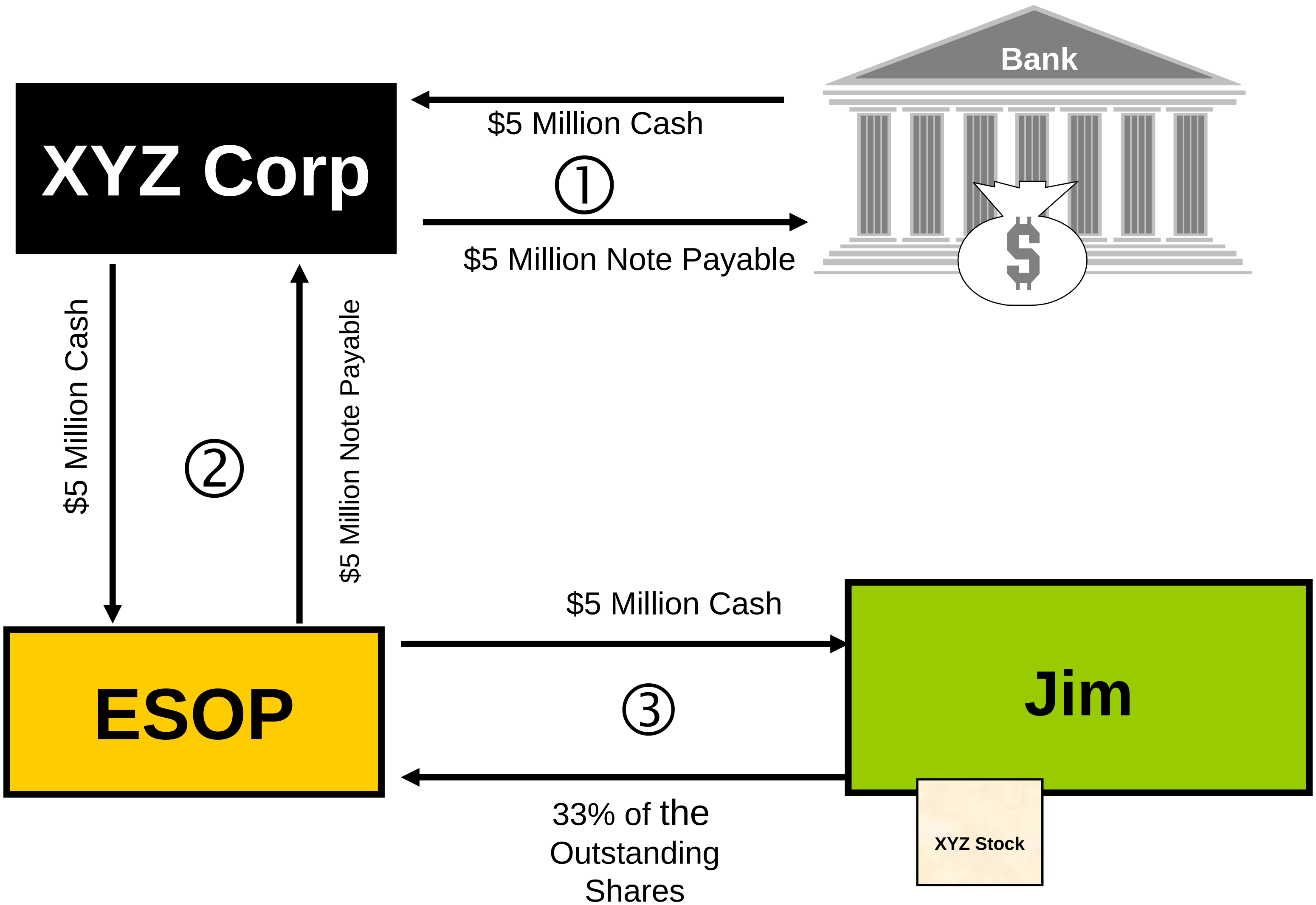
# Basic Leveraged ESOP Structure

- Leveraged ESOPs Structure
  - Outside loan vs. inside loan
  - Loan terms
  - Annual contribution limits
- Differences Between Inside and Outside Loans
- Release of shares
- Loan "Sizing"
  - Credit and collateral capacities

# Basic Leveraged ESOP: Example

- XYZ Company has been valued at $15 million on a minority, non-marketable basis
- ESOP purchases 33% of XYZ's stock from Jim for $5 million
- The stock purchase is financed with a $5 million loan, which will be repaid over time

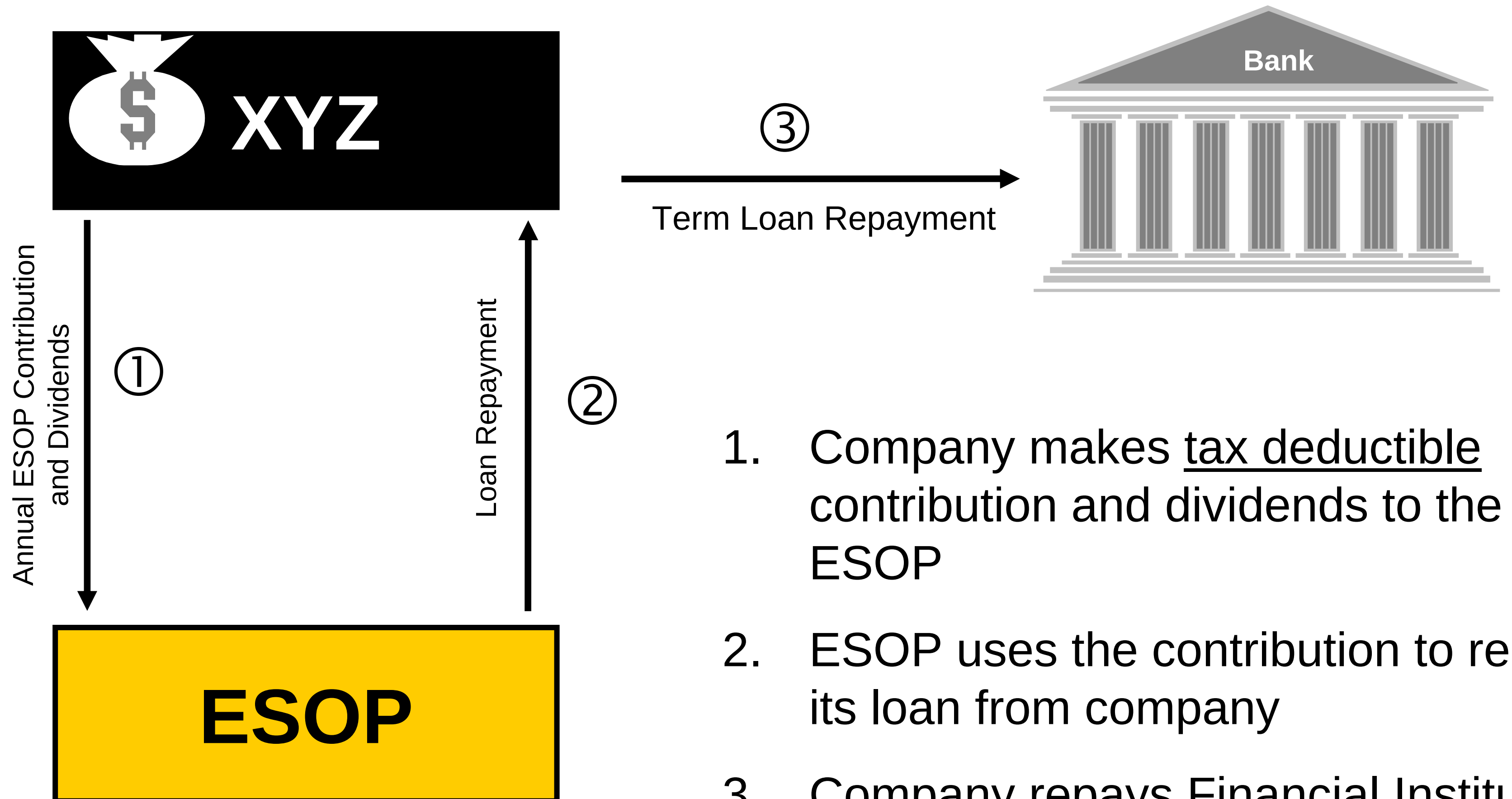
# Basic Leveraged ESOP



# Repayments of Inside & Outside Loans

- The company will make annual <u>tax deductible</u> contributions to the ESOP
  - Limitations exist for the maximum contribution each year; *generally,* think “25% of eligible payroll”
  - C-corporations may also deduct dividend paid on ESOP stock so long as it is used to repay debt or paid out to plan participants
- The ESOP will use the contributions it receives to make P&I payments on the debt that it borrowed from the company
- The company will make P&I payments to the financial institution (not necessarily the same as payment from the ESOP)

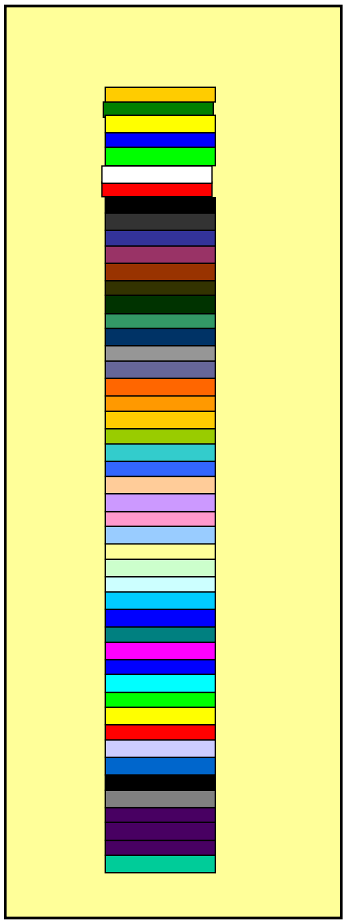
# Paying Off The Debt



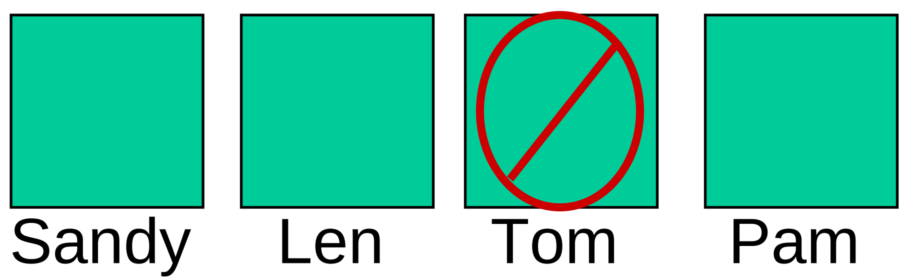

1. Company makes <u>tax deductible</u> contribution and dividends to the ESOP
2. ESOP uses the contribution to repay its loan from company
3. Company repays Financial Institution (not necessarily the same as payment from ESOP)

# Hypothetical Allocation

Suspense Account



- ESOP uses 2007 contribution to pay its note – this “releases” shares from suspense account
- Shares are allocated in proportion to compensation
- During 2008, new employees enter ESOP
- ESOP uses 2008 contributions and dividends/distributions from the company and then pays for more shares
- Separated employees generally do not get allocation of shares
- Process repeats annually until all ESOP shares have been put into accounts



# Pre-Transaction Balance Sheet

| | | | |
|---|---|---|---|
| CURRENT ASSETS | | CURRENT LIABILITIES | |
| Cash | $ 1,346,890 | A/P | $ 681,631 |
| A/R, net | 4,119,018 | Accrued expenses | 1,819,033 |
| Inventory | 564,457 | Current portion, LTD | 471,286 |
| WIP | 2,459,163 | Total Current Liabilities | 2,971,950 |
| Total Current Assets | 8,489,528 | | |
| PROPERTY AND EQUIPMENT | | | |
| PP&E, cost | 3,926,783 | Long-term debt | 488,410 |
| Less: Accum Depr | (2,574,892) | Total Liabilities | **3,460,359** |
| | 1,351,891 | | |
| | | OWNERS' EQUITY | |
| | | CS, PIC & Ret Earnings | 10,809,351 |
| | | (Treasury stock) | (4,134,563) |
| OTHER ASSETS | 293,728 | Owners' equity | 6,674,788 |
| **Total Assets** | **$ 10,135,147** | **Total Liabs & OE** | **$ 10,135,147** |

Total Debt to Net Worth 14%

# Post-ESOP Balance Sheet (GAAP Accounting, SOP 93-6)

| | | | | |
|---|---|---|---|---|
| CURRENT ASSETS | | CURRENT LIABILITIES | | |
| Cash | $ 1,346,890 | A/P | $ | 681,631 |
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| OTHER ASSETS | 293,728 | Owners' equity | | 1,674,788 |
| **Total Assets** | **$ 10,135,147** | **Total Liabs & OE** | **$** | **10,135,147** |

**Total Debt to Net Worth 356%**

# Post-ESOP: Year 2

| | | | | |
|---|---|---|---|---|
| CURRENT ASSETS | | CURRENT LIABILITIES | | |
| Cash | $ 1,346,890 | A/P | $ 681,631 | |
| A/R, net | 4,119,018 | Accrued expenses | 1,819,033 | |
| Inventory | 564,457 | Current portion, LTD | 971,286 | |
| WIP | 2,459,163 | Total Current Liabilities | 3,471,950 | |
| Total Current Assets | 8,489,528 | | | |
| PROPERTY AND EQUIPMENT | | | | |
| PP&E, cost | 3,926,783 | Long-term debt | 3,988,410 | |
| Less: Accum Depr | (2,574,892) | Total Liabilities | **7,460,359** | |
| | 1,351,891 | | | |
| | | OWNERS' EQUITY | | |
| | | CS, PIC & Ret Earnings | 10,809,351 | |
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| **Total Assets** | **$ 10,135,147** | **Total Liabs & OE** | **$ 10,135,147** | |

**Total Debt to Net Worth 185%**

# Bank Financing

- Pre-tax financing
- Loan sizing
- Collateral capacity
- Cash flow capacity
- Typical terms and conditions

# ESOPs Can Provide Companies with Greater Debt Capacity

Principal / Interest Tax Deductible

Greater After Tax Cash Flow

**Improved Debt Capacity**

# Regular vs. ESOP Debt Financing

| | Leveraged Redemption | Leveraged ESOP |
|---|---|---|
| Gross Principal Payments | $5,000,000 | $5,000,000 |
| Value of Principal Tax Deduction | - | (2,000,000) |
| Net After-Tax Principal Paid | 5,000,000 | 3,000,000 |
| Gross After Tax Interest Payments * | 750,000 | 546,000 |
| Net After-Tax Financing Cost | 5,750,000 | 3,546,000 |
| **Net Cash Savings Using ESOP** | | $ 2,204,000 |
| **Savings** | | 38% |

Assumes: Principal: $5 million, Interest Rate: 6%, Amortization: 5 equal annual principal payments, Tax Rate: 40%
* Cash tax savings applied to prepay principal, thereby reducing interest expense.

# Loan “Sizing”

- How much will the lenders lend?
  - Balance sheet debt capacity
  - Cash flow debt capacity

- How much should the company borrow?
  - Estimating marginal borrowing capacity

# Balance Sheet

| | | | |
|---|---|---|---|
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| OTHER ASSETS | 293,728 | Owners' equity | 6,674,788 |
| **Total Assets** | **$ 10,135,147** | **Total Liabs & OE** | **$ 10,135,147** |

# Balance Sheet Collateral Capacity

| Asset | Cost | Adjustment to Cost | FMV Assets | Advance Rate | Borrowing Capacity |
|---|---|---|---|---|---|
| Cash | $ 1,346,890 | $ - | $ 1,346,890 | 0% | $ - |
| A/R, net | 4,119,018 | (163,937) | 3,955,082 | 75% | 2,966,311 |
| Inventory | 564,457 | - | 564,457 | 60% | 338,674 |
| WIP | 2,459,163 | - | 2,459,163 | 0% | - |
| PP&E, Net | 1,351,891 | 250,000 | 1,601,891 | 60% | 961,135 |
| Other assets | 293,728 | - | 293,728 | 0% | - |
| | $ 10,135,147 | $ 86,063 | $ 10,221,210 | | $ 4,266,120 |

# Income Statement

| | Years Ended December, 31 | | | | |
|---|---|---|---|---|---|
| | **2003** | **2004** | **2005** | **2006** | **2007** |
| NET SALES | $ 21,198,585 | $ 21,867,053 | $ 22,782,211 | $ 29,832,015 | $ 32,431,024 |
| COST OF SALES | 14,391,229 | 14,601,611 | 14,699,094 | 19,191,130 | 21,932,979 |
| GROSS PROFIT | 6,807,356 | 7,265,442 | 8,083,117 | 10,640,885 | 10,498,045 |
| SG&A Expenses | 5,241,742 | 5,804,188 | 6,393,001 | 7,588,468 | 7,916,341 |
| Income from Operations | 1,565,614 | 1,461,254 | 1,690,116 | 3,052,417 | 2,581,704 |
| OTHER INCOME AND EXPENSES | 318,716 | 265,307 | 180,801 | 463,113 | 760,762 |
| Income Before Tax | 1,884,330 | 1,726,561 | 1,870,917 | 3,515,530 | 3,342,466 |
| Taxes | 719,247 | 655,539 | 707,689 | 1,319,808 | 1,258,419 |
| | **$ 1,165,083** | **$ 1,071,022** | **$ 1,163,228** | **$ 2,195,722** | **$ 2,084,047** |
| EBITDA | $ 1,731,793 | $ 1,606,646 | $ 1,862,406 | $ 3,218,467 | $ 2,765,362 |
| **Average EBITDA** | **$ 2,236,935** | | | | |

# Important Ratios & Considerations

- Ratios
  - Fixed Charge Coverage Ratio

$$\frac{EBITDA + ESOP\ Expense - Cash\ Taxes - Maintenance\ CAPEX}{Interest\ Expense + Debt\ Principal\ Payments}$$

  - Leverage Ratios:
    - Debt-to-Equity Ratio: ESOP contra equity account is ignored
    - Debt-to-EBITDAE
- Owner Expense “Addbacks”
- Future borrowing needs
  - Other projects and variances
- ESOP share repurchases
- Balance sheet impact of leverage ESOP

# Sample Leverage Analysis

| DEBT RATIO ANALYSIS | | Day 1 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|---|---|
| | **EBIT** | | $ 2,150,796 | $ 2,430,660 | $ 2,695,131 | $ 2,897,262 | $ 3,109,501 |
| | Plus: Depreciation & Amortization | | 485,704 | 519,760 | 551,944 | 576,541 | 602,368 |
| | Plus: Non Cash ESOP Expense | | 1,287,500 | 1,287,500 | 1,287,500 | 1,287,500 | 1,287,500 |
| | Less: Capital Expenditures | | (425,704) | (459,760) | (491,944) | (516,541) | (542,368) |
| | Less: Cash Taxes | | (530,297) | (694,438) | (839,618) | (967,816) | (1,108,787) |
| A | Cash Flow Available for Debt Service (CFADS) | | $ 2,967,999 | $ 3,083,721 | $ 3,203,013 | $ 3,276,946 | $ 3,348,213 |
| B | Senior Interest Expense | | $ 812,500 | $ 661,547 | $ 544,970 | $ 410,622 | $ 252,858 |
| C | Subordinated Cash Interest Expense | | - | - | - | - | - |
| D | Total Interest Expense (B+C) | | 812,500 | 661,547 | 544,970 | 410,622 | 252,858 |
| E | Senior Required Debt Payments | | 1,562,500 | 1,562,500 | 1,562,500 | 1,562,500 | 1,562,500 |
| F | Subordinated Required Debt Payements | | - | - | - | - | - |
| G | Total Required Principal Payments (E+F) | | 1,562,500 | 1,562,500 | 1,562,500 | 1,562,500 | 1,562,500 |
| H | Total Debt Service (D+G) | | $ 2,375,000 | $ 2,224,047 | $ 2,107,470 | $ 1,973,122 | $ 1,815,358 |
| I | Total Senior Debt Outstanding | 12,500,000 | 10,177,651 | 8,384,156 | 6,317,267 | 3,890,130 | 1,258,599 |
| J | Total Subordinated Debt Outstanding | - | - | - | - | - | - |
| K | Total Debt Outstanding | $ 12,500,000 | $ 10,177,651 | $ 8,384,156 | $ 6,317,267 | $ 3,890,130 | $ 1,258,599 |
| **DEBT SERVICE COVERAGE RATIOS** | | | | | | | |
| | Senior Interest Coverage (A/B) | | 3.65x | 4.66x | 5.88x | 7.98x | 13.24x |
| | Senior Debt Service Coverage (A/(B + E)) | | 1.25x | 1.39x | 1.52x | 1.66x | 1.84x |
| | **LEVERAGE RATIOS** | | | | | | |
| | Senior Debt/CAFDS (I/A) | | 3.43x | 2.72x | 1.97x | 1.19x | 0.38x |
| | Senior Debt/EBTIDAE | 3.69x | 2.59x | 1.98x | 1.39x | 0.82x | 0.25x |

# Loan "Sizing": Cash Flow Capacity

| | | |
|---|---|---|
| Average EBITDA | $ | 2,236,935 |
| Divide by Cash Flow Coverage "Safety" Ratio | | 1.50 |
| Net Cash Flow Available for Debt Service | | 1,491,290 |
| | | |
| Cash Flow Debt Capacity (5 yrs, 6.5%) | | $6,197,323 |
| less: Existing debt | | (959,696) |
| Cash Flow Borrowing Capacity | | $5,237,627 |

# Loan "Sizing" Summary

| | |
|---|---|
| ➢ Balance sheet borrowing capacity | $4,250,000 |
| ➢ Cash flow borrowing capacity (rounded) | $5,250,000 |

- ➢ Company value estimated at $15 million
- ➢ ESOP purchase will require $5 million

# Collateral Shortfalls:
# How do we get there from here?

- Additional debt could be borrowed over and above the "stand alone" amount using one or more of the following approaches:
  - Senior Debt - "Airball"
  - Limited personal guaranty / Pledge backs
  - Mezzanine debt
  - Seller debt

# Senior “Airball”

- Airball is the portion of senior debt not collateralized
- Company must exhibit stable cash flows to be a candidate
- Senior lenders “might” be persuaded to finance an airball up to 18 months in duration
- Airball is the first debt to be amortized
- Given the greater risk relative to a collateralized loan, airball carries higher interest rates

# Limited Personal Guaranty

- Selling shareholder makes a limited guaranty for the uncollateralized portion of the loan
  - Limited guarantee is secured by personal assets
  - Typically, sale proceeds are used as collateral to support limited guaranty
  - Limited guaranty typically “ratchets” down annually as company pays down principal and loan/value ratio decreases

# Types of Financing

- From Least Expensive to Most Expensive
  - Secured debt
    - Senior bank debt
    - Asset based financing
  - Unsecured debt
    - Mezzanine
    - Term B
    - Seller Notes
- Other Financing Sources
  - Roll-over 401(k) or PSP funds
  - Key Management financing (most junior)
  - Vermont Employee Ownership Loan Fund

# Secured Debt

- Commercial loan
  - Most prevalent and least expensive form of secured debt
  - The low cost comes with more restrictive loan covenants and conditions than other forms of financing
  - Loan terms do not typically exceed 7 years
  - Interest rate pricing depends on total leverage, cash flow coverage and collateral quality
- Asset based financing
  - More monitoring and administration than commercial loan
  - Loan amounts directly tied to value of the current asset base

# Typical Senior Debt Financing Terms

- Revolver + ESOP Term Loan(s)
  - Secured with borrowing base and advance rates
  - May require pledge of proceeds
  - May require personal guarantees
  - May need subordinated debt (seller or mezzanine)

- Covenants - liquidity, leverage, coverage
  - Senior debt capacity up to 3.0x EBITDA

- Up 7 year terms, longer amortization occasionally available
- Pricing base + 1.50% - 4.00% (typically LIBOR, Prime)
- Fees .00% to 3.0%
- Due Diligence Costs

# Unsecured Debt: Seller Debt

- Selling shareholder receives a note from the company or ESOP as consideration for all or a portion of the ESOP shares sold
  - Note will likely come from ESOP if seller is electing installment sales treatment
  - Note will likely come from Company if the seller is taking IRC 1042
- Seller debt subordinated to senior debt
- Higher risk inherent in seller debt security can result in higher interest rates
  - This added return typically comes in the form of warrants, or a right to buy stock at some future date at a specified price

# Unsecured Debt: Mezzanine

- **What is it ?**
  - "Cheap Equity"
  - Smaller pieces typically provided by SBIC sponsored funds
  - Subordinated to senior debt, but senior to seller debt
- Because it is taking on greater risk than the senior lender it requires a higher return
- May require return of up to 15%-25% by way of:
  - Current interest coupon of 10%
  - Warrants (stock options) for equity for the balance of the return

# Financing a Partial ESOP

- Partial ESOPs are usually financed with Bank Debt or a combination of Bank Debt and Seller Notes
  - Bank debt is always senior to other loans
  - “Junior debt” can not amortize more quickly than senior debt
- How much can the company afford?
  - Start by estimating company’s cash flow needs and capital needs for the next 5 years
    - Typically uses are working capital for growth and capital expenditures or acquisitions
    - Consider how much cash flow capacity is “left over” (after other needs) for an ESOP transaction
  - Prepare for bank meeting
  - Meet with lenders and solicit ideas and proposals
  - Negotiate terms and conditions - close financing

# Financing a Partial ESOP (cont'd.)

- Loan terms have to be priced "fairly"
- Seller notes can pay a higher return than senior debt, but only if return is commensurate with risk

Example:

- Seller wants to finance the entire deal and has heard seller notes "pay 15%"
- Assume company has no other debt, the "seller notes" need to bear a "senior" cost on all or part of the financing

# Financing A 100% ESOP

- 100% buyouts will require several tranches of capital
  - Bank debt, mezzanine/cash flow debt, seller notes and perhaps management notes
  - Rollover money from other retirement benefit plans also a source of cash
- Junior debt (all but bank debt) will pay part of its return in cash and part as a balloon payment
  - This balloon is typically in the form of an equity warrant
- All debt has to be appropriately priced
  - E.g., senior debt typically does not get more than seller notes

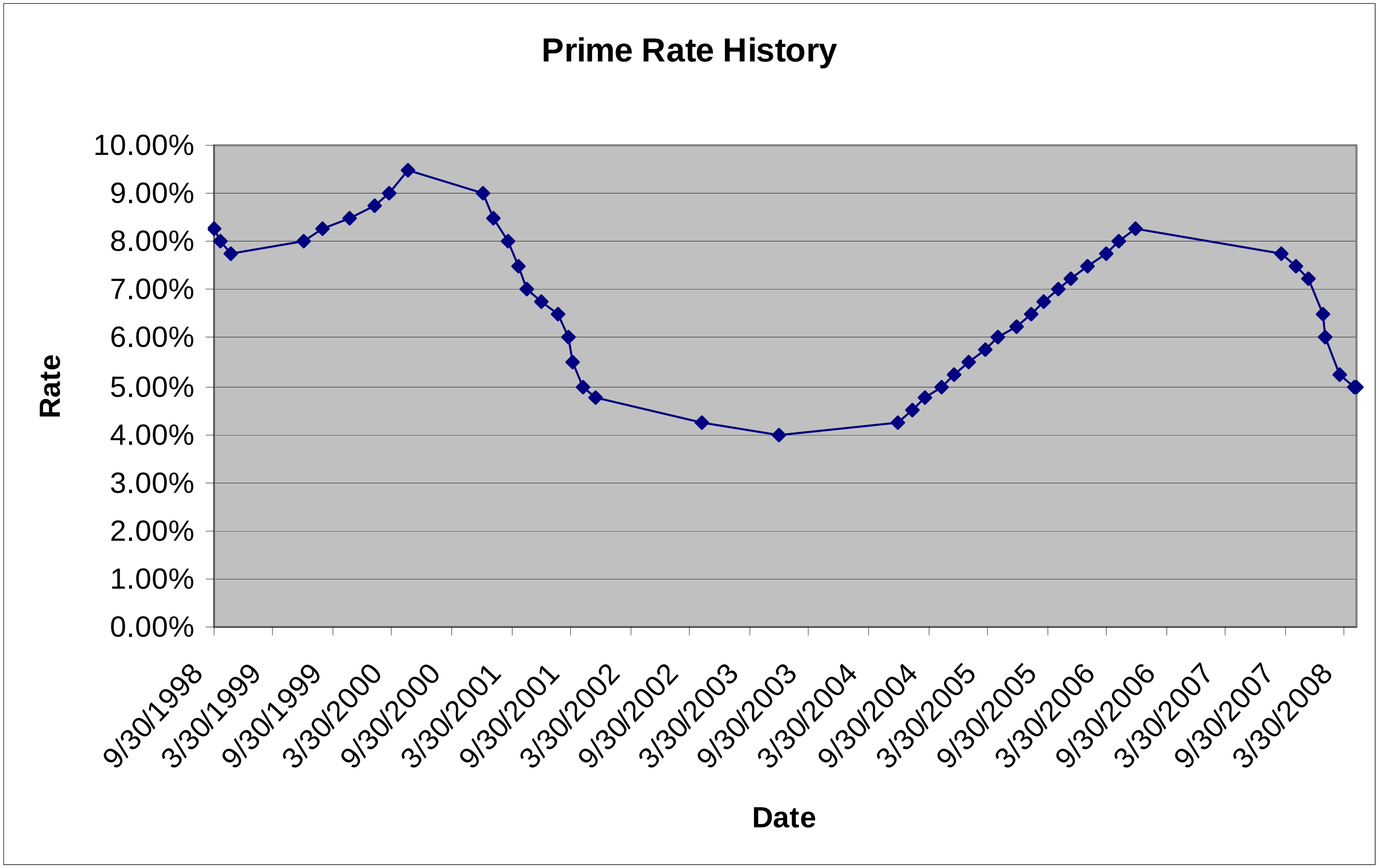
# Second Stage ESOP Considerations

- Deferred capital projects / expenditures
- Repurchase liability
  - Timing of payouts on first stage shares
- Post-transaction price changes
  - Effect on subsequent transactions and distributions to retirees (floor price?)

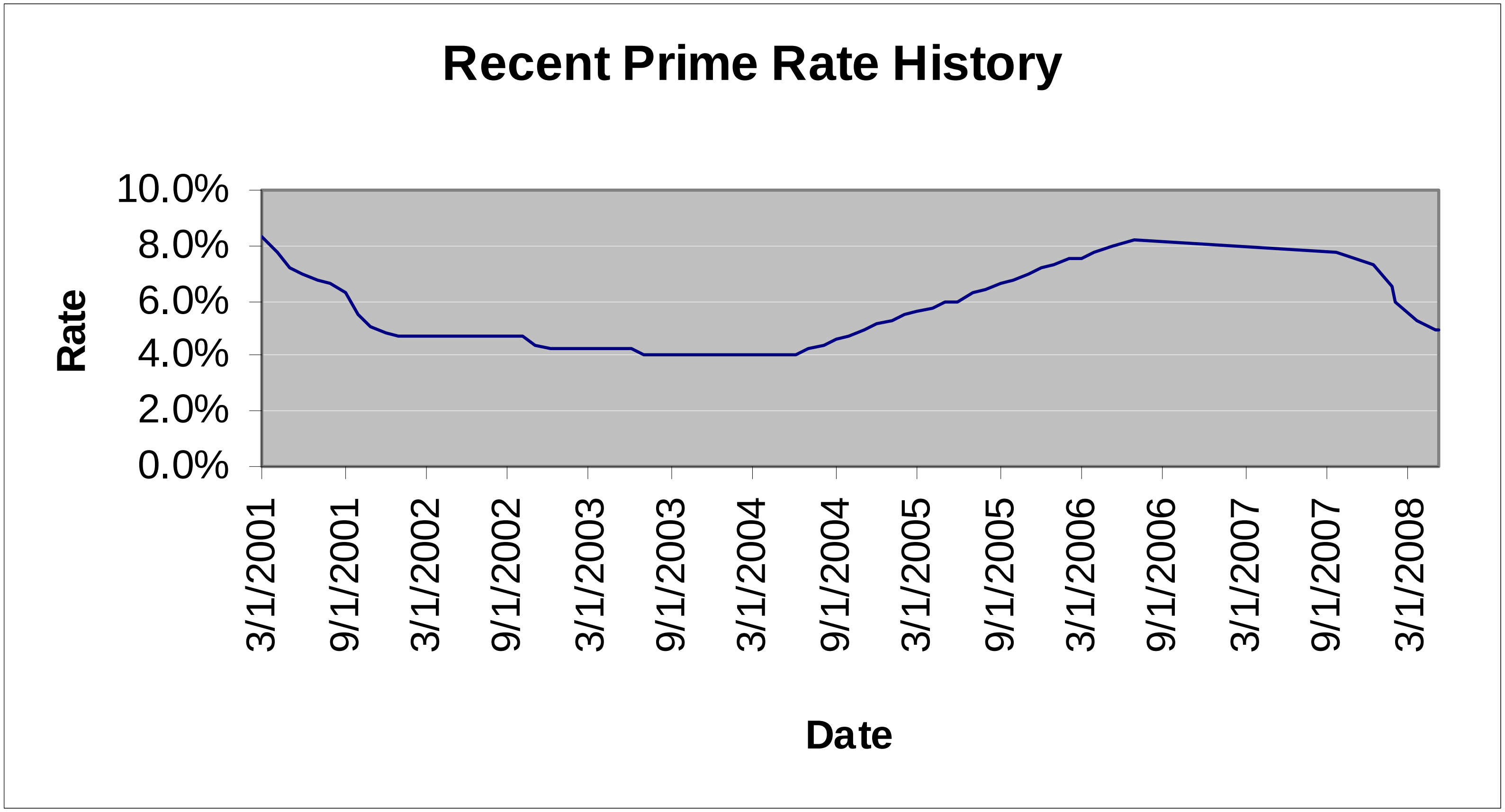
# Banking Environment Today

- Senior Debt to Cash Flow is Up to ~ 3.00x's
- Credit standards have tightened substantially over the past six months
- Spreads over cost of funds increasing, though at a slower rate
- Short term rates are still quite favorable thanks to the Fed and the weaker economic environment
- ESOP loan transactions ARE getting done!

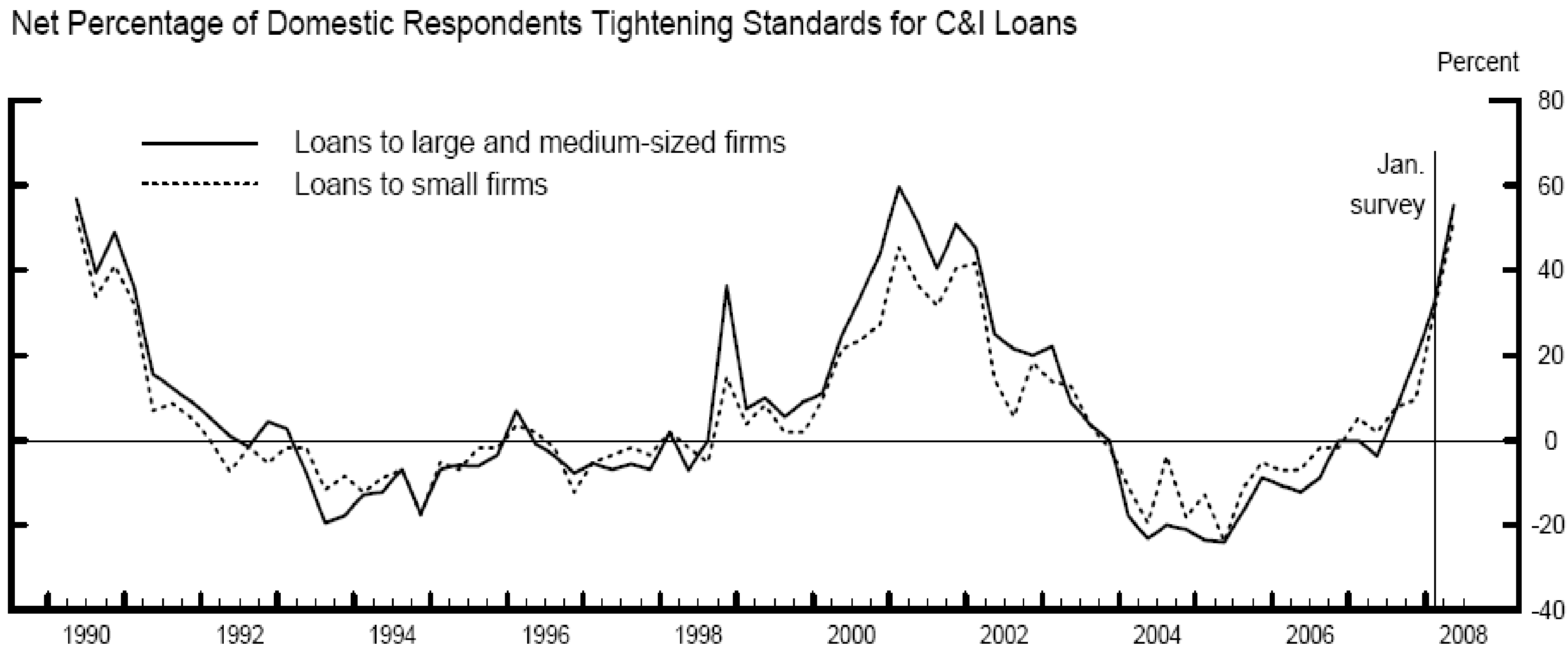
# Short Term Rates Have Dropped...



# ...And Are Still Low, Relatively

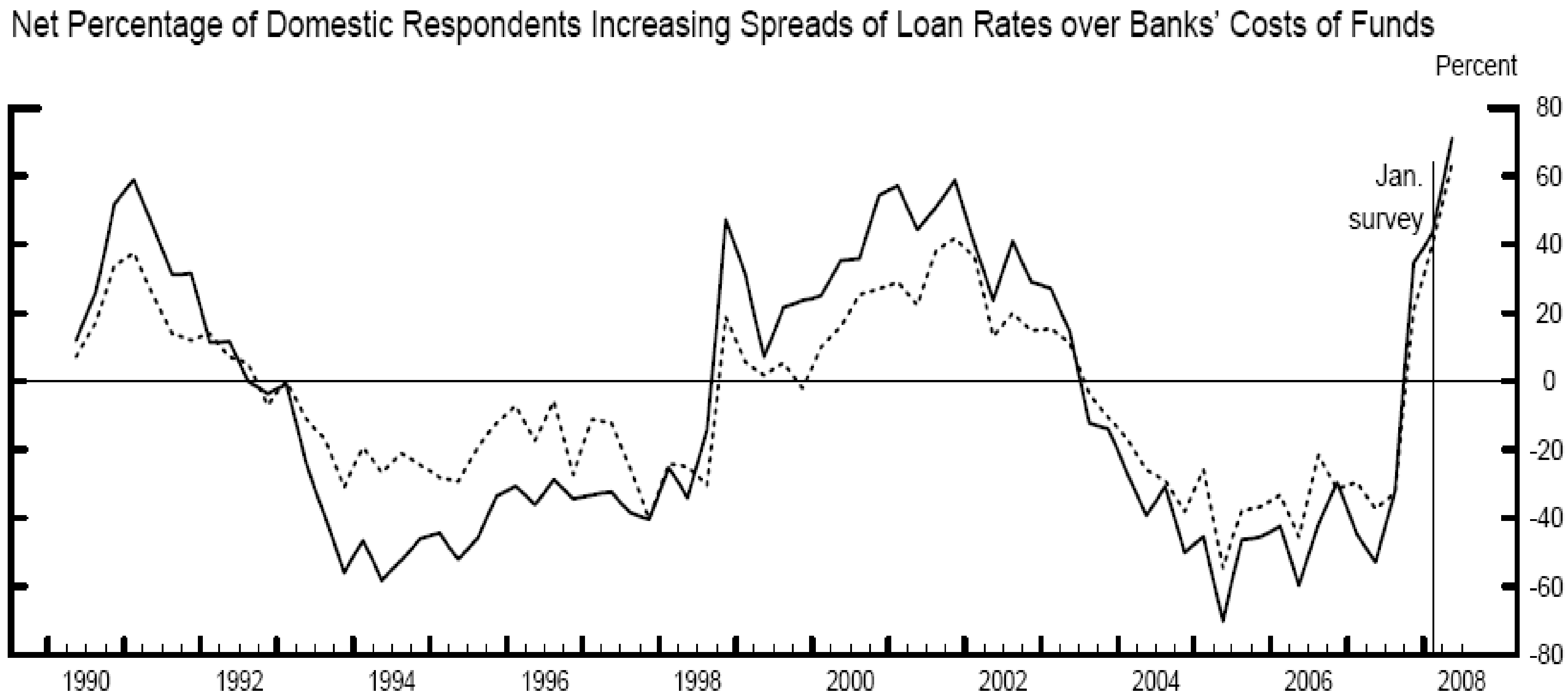


# Banks Continue to Tighten Credit Standards



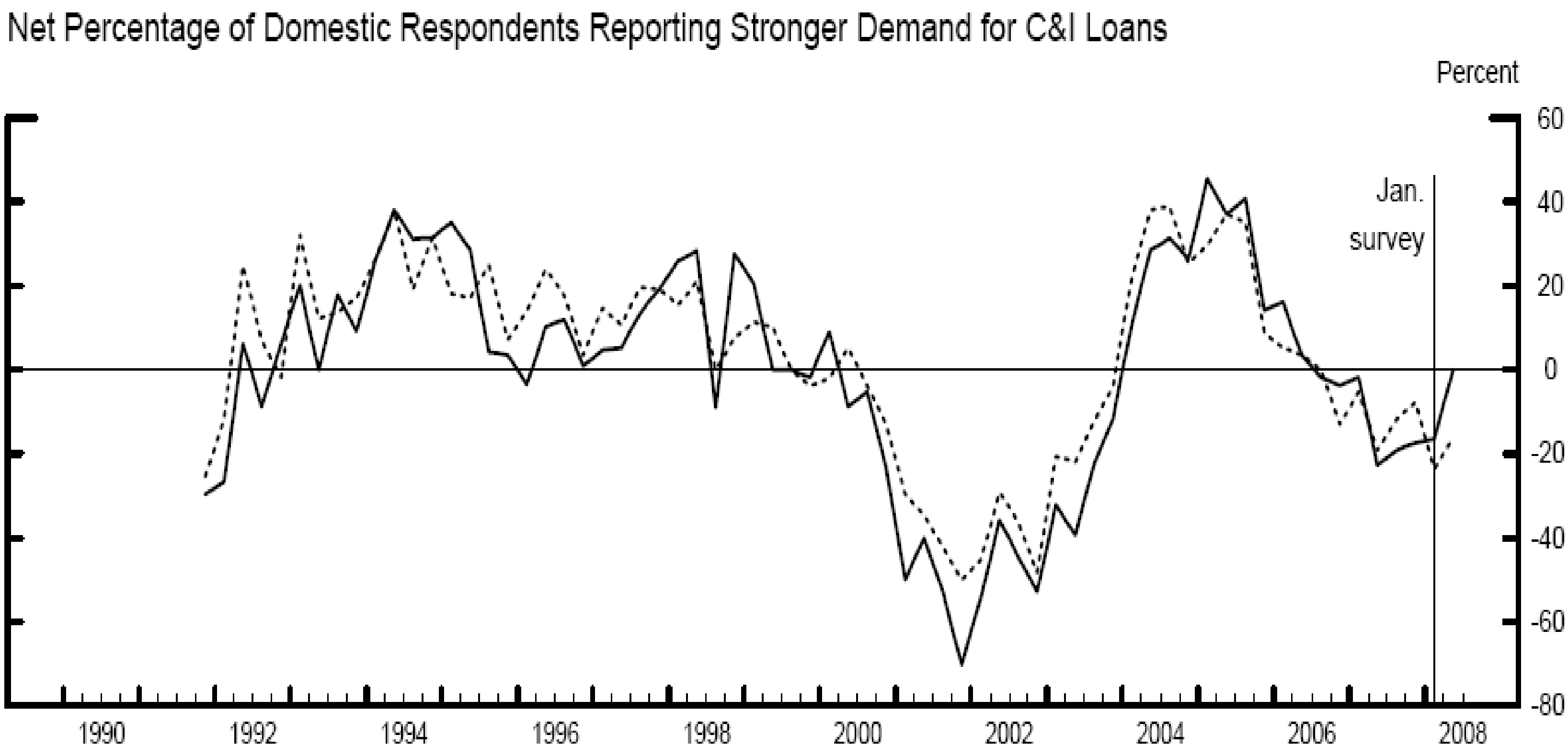

Source: Federal Reserve, Sr. Loan Officer Survey, April 2008.

# Banks Have Increased Spreads Since Q2:07




Source: Federal Reserve, Sr. Loan Officer Survey, April 2008.

# Loan Demand Is Off Considerably...
# But may be rebounding?




Source: Federal Reserve, Sr. Loan Officer Survey, April 2008.

# Preparing For Your Bank Meeting

- Be prepared to “sell” your business
- Discuss and explain the company’s:
  - Historical financial performance
  - Strengths and weaknesses
  - Opportunities and risks in the industry
  - Succession strategy
- Prepare realistic projections
- Propose a borrowing amount and structure
- Show debt service coverage

# ESOP Financing Summary

- Start early - feasibility study, transaction analysis, assemble good team of advisors
- Develop a written business plan that addresses all key issues
- Understand and address the issues and perspective of the capital providers
- Prepare to “sell” your company

# Thank You Audience and VEOC !

**"Financing an ESOP"**
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