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Wealth Planning Update

Employee stock ownership plan vs. management buyout

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Key takeaways:

- When considering the transition of your business, a sale to an employee stock ownership plan (ESOP) and a management buyout (MBO) are two alternatives that allow the business to continue to be run by your existing employees.
- An ESOP allows all of the employees to have ownership in the business and can include tax advantages.
- An MBO allows you to choose which key employees the business is sold to.

What this may mean for you:

- It is important to review the strengths and weaknesses of an ESOP and an MBO and see how they align with the facts and circumstances of your situation in order to determine if either transition alternative is the right fit for your business.

Transitioning a business is a monumental step for a business owner. Therefore, it is important to understand your options to have confidence that the transition option you ultimately choose is right for you. As you evaluate your alternatives, two options that are commonly compared side by side are an ESOP and an MBO. Approximately 25% of business owners transition via an MBO, while nearly 5% transition via an ESOP.[1] Although the numbers show a preference for an MBO, a thorough review of these two options should be undertaken to know which path is right for you and your business or if an alternate path may be appropriate.

1. EPI, Georgia State of the Owner Readiness, 2018

When evaluating these two options, there are several factors to consider. Some of these include business valuation, tax characteristics (federal and local), deal structure, repayment risk, ongoing personal or family involvement in the business, buyers' financial capacity to purchase, and transition timeline, to name a few. A professional with experience in ESOPs and MBOs can help you assess these factors and assist in determining which path is right for you.

To help you get started, consider the following questions:

- Which employees should have ownership in your business when you transition?
- How will the employees obtain ownership?
- Why do you want your employees to own your company?
- What do you need to net from the business sale to fulfill your personal financial goals?
- Can your employees think and act like owners? Why or why not?
- How much debt will the business need for growth over the next five years?
- Who will fill your role when you are no longer involved in the day-to-day operations of the business?

Employee stock ownership plan (ESOP)

An ESOP is a qualified plan regulated by the Employee Retirement Income Security Act of 1974 (ERISA), which is a federal tax and labor law that establishes minimum standards for pension plans in private industry. ESOPs are typically appropriate for companies with earnings before interest, taxes, depreciation, and amortization (EBITDA) in excess of $1 million. ESOPs are most common among government contractors and technology, manufacturing, engineering, architecture, and distribution companies. While only 3% to 5% of companies implement an ESOP, on average ESOP companies have a historical tendency to outperform their peers and retain employees at a higher rate, especially during times of economic downturn, like the financial crisis and the recent pandemic.[2]

There are several considerations in determining if an ESOP is a fit for you and your company. We recommend thoroughly reviewing your situation with a professional. A few key ESOP considerations include:

- What percentage of your ownership will you sell to the ESOP? ESOP transactions can be 100% or a partial sale of the business (for example, 30%, 49%, 51%), which offers a great solution for business owners who don't want to initially (or ever) sell 100% or when multiple selling shareholders don't agree to sell because not all have to.
- In a transaction where the ESOP buys more than 50%, seller financing typically occurs in conjunction with bank financing; that is, the seller will receive some cash at closing combined with some percentage in a seller note that is paid out over time with interest. This allows the selling shareholder to receive some liquidity at closing without putting too much strain on the business's cash flow.
- An ESOP feasibility study should occur during the exploratory phases of an ESOP transaction to test the ESOP's viability. (A preliminary assessment is also highly recommended to ensure the basic parameters are in place before commencing a feasibility study.)
- There are several roles to be filled during the creation and ongoing operation of an ESOP. These include a consultant, an independent trustee, an independent business valuation professional, an ESOP attorney, and an ESOP administrator.
- The makeup of the post-ESOP management team is another crucial consideration for the future success of your business. If you are retiring, what will your role be post ESOP? Do you have sufficient bench strength to replace you? Incentive plans are normally provided to management teams of ESOP-owned businesses. These incentive and compensation structures should be reviewed as part of the ESOP feasibility study.

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2. NCEO, BusinessWire, GBQ

One of the main benefits of an ESOP is the related tax incentives, which may become even more attractive with anticipated tax rate increases looming. Plan contributions are tax deductible, and S-corporation stock owned by the ESOP is not subject to income tax. Also, shareholders of a C-corporation may qualify to defer capital gains taxes on the sale of their shares to the ESOP. ESOPs are allowed to take ownership only in corporations (there are private letter rulings that allow LLCs taxed as a corporation to be owned by an ESOP). ESOP and tax professionals can advise you on appropriate tax-related strategies based on your existing corporate structure.

Management buyout (MBO)

An MBO is a term used for two scenarios: when one shareholder buys all of the shares of another shareholder in a business or when a key employee or employees buy all of the shares of one or more of the current shareholders. As you consider the MBO path, it is important to distinguish between these two scenarios and which is appropriate for your situation.

When selling to a partner, key considerations include:

- The impact of your current buy-sell agreement on the transaction. Not all multi-owner businesses have a buy-sell, and some may prefer to negotiate outside of this agreement. With this said, this agreement can facilitate the transition for you, as it defines how value is determined, how you will be paid, and other terms of the transaction.
- Your involvement in the business post transition. Some owners desire to remain involved in the business at some level, especially if there is repayment risk of a seller note that can be mitigated through your continued involvement. Others may want to continue their involvement to stay linked to the business they created.
- Define your Plan B if you are unable to negotiate acceptable terms. Your partner may not want to buy your shares due to their planned exit, liquidity concerns, or other reasons. In this event, an alternative plan should be considered.

When selling to a key employee or employees, important considerations include:

- If more than one employee will become an owner, dynamics between the employees will likely change as they put on their new owner hats. You may need to provide education on what it means to have ownership and assist them as they grow into their new roles. This group may need help from you or a professional to assist in determining their respective ownership percentages, buy-sell terms, financing, etc.
- Most W-2 employees will rely largely on the free cash flow of the company to purchase your business. MBOs that rely on the business free cash flow generally occur at business values below $5 million, as the deal economics become more challenging at values above $5 million. Most of these deals, regardless of value, come at a value discount due to the use of business cash flow as the primary means of repayment.
- Seller notes are common in these transactions. Repayment risk should be identified and quantified to ensure you understand and are comfortable with your risk, especially if the proceeds of the seller note are required to meet your personal financial goals.
- Management structure and decision-making processes post transition should be established. What position will each new owner have post sale? What will your role be in the business? Additionally, clear rules should be created for the new ownership group to facilitate decision-making. A buy-sell should be strongly considered for the next generation of owners, if there is to be more than one.

Potential disadvantages

As with all transaction types, there are pros and cons to weigh when deciding which strategy to pursue. Some potential disadvantages to consider with ESOP and MBO transactions include:

- Sales price - a strategic buyer may be willing to pay a premium to acquire your company that likely cannot be captured under an ESOP or MBO transaction. Having sufficient post-transaction liquidity and cash flow may be critical to ensuring you are able to meet your personal financial goals.
- Repayment risk - many of these transactions rely on financing, which means the ability of the company or the new owners to cover the debt service is likely dependent on the company's ability to maintain a certain level of cash flow.
- Operational continuity - often the executive team is new to being a business owner and has not had to make many of the decisions you made as owner. To the extent you will continue to be involved or from a legacy perspective, are you comfortable turning the company management over to them?

Conclusion

For many business owners, comparing an ESOP and an MBO is an important step in evaluating the transition options. To determine which path is right for you, a thorough review of these two options is advised. If you are interested in talking with a professional from Wells Fargo that can assist you in evaluating these two transition options as well as others, please reach out to your relationship manager.

Sources:

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Disclosures

EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) is an approximate measure of a company's operating cash flow data from the company's income statement.

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