ESOP Financing: Where's the Cash?

How a leveraged ESOP can help you achieve your financial goals

An Employee Stock Ownership Plan (ESOP) can be an ideal solution to business owners seeking a shareholder liquidity event or exit strategy. ESOPs can create an opportunity for the owner of a privately held company to diversify their net worth, partially or in whole, from their single largest asset - their business. Benefits to the employees include real ownership in the company, incentives, reward for corporate growth and significant tax benefits. Arranged properly, an ESOP can actually create a tax-free sale for the owner and a tax-deductible purchase for employees.

Since all business owners will want to reduce their exposure to the business and monetize their equity at some point, a "leveraged" or financed ESOP structure is critical. A leveraged ESOP provides cash at closing to enable to selling shareholder to achieve their financial goals and generate immediate cash for living expenses, investments, retirement and wealth transfer planning. Additionally, a leveraged ESOP provides the funds for the company to execute the purchase with the most favorable terms and conditions in the marketplace. Since the company and its employees are rarely in a position to provide the cash required for closing, a professionally-run, competitive process is key to ensuring the most attractive financing for the transaction.

To illustrate, let's look at the following example:

- Company in business for 30 years, owned by a single founding shareholder
- Owner desires to sell shares to ESOP in exchange for cash and is willing to seller finance the balance
- Revenue of the company is $30 million
- Earnings before interest, tax, depreciation and amortization (EBITDA) are $4 million
- Valuation for ESOP sale is $24 million or six times current EBITDA

TRANSACTION OVERVIEW	
ESOP Transaction	
Latest-Twelve-Months EBITDA	$4.0
Valuation Multiple (xEBITDA)	6.0x
Sale Price	**$24.0**
3rd-Party Lender Financing	*50%*
Seller Financing	*50%*
Capital Sources	
Senior Lender	$8.0
Mezzanine Lender	$4.0
Seller Note	$12.0
Total Proceeds	**$24.0**

SELLER PROCEEDS	
At Closing	
Proceeds from Senior / Mezz Lender	$12.0
Cash on Balance Sheet	$1.5
Payoff of Existing 3rd-Party Debt	($1.0)
Transaction Costs	($1.2)
Cash at Close	**$11.3**
Pre-Tax Seller Proceeds	
Cash at Closing	$11.3
Seller Note Principal	$12.0
Seller Note Interest	$3.0
Warrant Securities	$5.6
Total Pre-Tax Seller Proceeds	**$31.9**

The competition created among multiple financing sources for both senior and mezzanine financing is key to the owner receiving significant cash at closing and provides the ESOP participants with the capital required to buy the shares.

In this example, the seller receives 50% of the purchase price in cash at closing while taking a note for the balance. If the goal is to maximize total cash at closing and reduce the seller's exposure to the business post-closing, mezzanine financing can be utilized as shown. If, however, the seller is comfortable taking less cash at closing, then the deal will likely be financed by senior debt plus the seller note, which will allow for more warrants. Warrants can provide for meaningful upside for the seller, or in some cases the management team, driven by the company's growth post-closing and repayment of ESOP debt by the company.