



INSIGHT

ESOP Myths and Realities

Contrary to popular opinion, an employee stock ownership plan is not a financial panacea.

When owners of privately held companies consider their ownership transition options, invariably, the subject of an ESOP comes up. The popular press routinely touts ESOPs as having some mystical quality that defies the laws of economics, allowing sellers to achieve a value not otherwise obtainable. The truth is that the sale of a business to an ESOP is the optimal alternative in only a very narrow set of circumstances. Instead of a panacea to the world of corporate finance, ESOPs are usually not the highest value alternative and can constrain the ability of many businesses to remain competitive in today's fast pace marketplace.

WHAT IS AN ESOP?

An ESOP, or Employee Stock Ownership Plan, is a type of tax qualified retirement plan that invests primarily in securities of the employer. Unlike other retirement plans, ESOPs have the ability to borrow money to purchase employers' stock; these plans are referred to as leveraged ESOPs. ESOP plans are structured like profit sharing plans that hold

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company stock in trust, which is then allocated to individual employee accounts as they vest. At retirement or termination, employees have the ability to sell vested shares back to the ESOP or to the company. The proceeds

TIME TO BUILD THE TEAM?

Great companies take advantage of difficult economic conditions to strengthen their position. For most in this environment, this does not mean investing additional capital but does mean building management bench strength.

During the recent "boom" years, we saw very few résumés circulating. Now, each week we receive many résumés from people who appear to be top talent. And, while it is always difficult to decide to increase payroll, building a strong team is a prerequisite to building a great company. Jim Collins, in his recent book, *Good to Great* offers some compelling insights into the importance of management. Among his findings are:

- Great companies result from great teams first, not great strategies. In Collins' words, "Get the right people on the bus, the wrong people off the bus and then figure out where to drive it.
- Whether someone is the "right person" has more to do with character traits and innate capabilities than specific knowledge, background or skills. In Collins' words, "The old adage that people are the most important asset is wrong. People are not the most important asset, the right people are.
- There is no systematic pattern linking executive compensation to great performance. In Collins' words, "the right people will do the right things and deliver the best results they're capable of, regardless of the incentive system.

So take advantage of this unique time in the market to find the best team to drive your company into the ranks of the great. ♦

can then be rolled over tax free into an Individual Retirement Account ("IRA").

In its simplest form, an ESOP receives contributions of stock directly from the company, which are then used to either purchase stock from the company or from selling shareholders. In the more complex leveraged ESOP, the ESOP borrows money from a financial institution and uses the loan proceeds to fund the purchase of company stock. As a practical matter, banks typically make ESOP loans to the company that in turn lends the funds to the ESOP. As a result,

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the company's operating cash flow is the primary source of repayment. The company must also make contributions to the ESOP to pay plan expenses and to repurchase shares from departing ESOP participants.

WHAT'S IN IT FOR THE SELLING SHAREHOLDER?

The primary economic incentive for shareholders to sell to an ESOP is the deferral on the gain from the sale of shares. Once an ESOP owns 30%, selling shareholders can elect to reinvest the cash proceeds from the sale to the ESOP in qualified securities and thereby defer any capital gains tax until those securities are sold. If the securities remain in the estate after death, the beneficiaries get a "free" step up in basis and eliminate the capital gains tax altogether.

Many prospective sellers interpret this tax deferral as receiving 25% more in after-tax proceeds than would be achieved in an equivalently priced taxable transaction. And, while it is true that there has been a

tax savings from the initial sale, until the ESOP repays the debt, the total amount of the seller's wealth actually declines.

Assume that a company with no debt and an enterprise value of \$10 million borrows \$3 million to purchase stock from selling shareholders. At the closing of that transaction, the selling shareholders' wealth declines from \$10 million to \$7.9 million as is illustrated below.

(\$ IN MILLIONS)	PRE-ESOP	POST-ESOP
Enterprise Value	10.0	10.0
Debt	—	(3.0)
Equity Value	10.0	7.0
Shareholder Ownership (%)	100.0	70.0
Shareholder Value	10.0	4.9
ESOP Sale Proceeds	—	3.0
Total Combined S/H Value	10.0	7.9

Over time, if the company generates sufficient cash flow to retire the ESOP debt (and otherwise maintains its value), this situation reverses itself.

In all but the most credit worthy situations, lenders will require real security for the borrowing which may include a pledge of sale proceeds or the seller's guarantee. The implication is that, although the seller may have "sold" the firm, he or she may remain at risk to its performance.

WHAT'S IN IT FOR THE COMPANY?

The benefit most often touted for leveraged ESOP companies is the tax deductibility of debt repayments. The fact is that the deduction is the same as any tax deduction that the company would otherwise receive for employee compensation.

A leveraged ESOP introduces new debt into a company's capital structure. Lenders evaluate the credit worthiness of an enterprise no different than a business that borrows for operating purposes. The difference is that borrowing for operating purposes typically creates new cash flows to service the debt, whereas borrowing to fund an ESOP extracts capital from the enterprise and encumbers existing cash flow. It is for this reason, that capital-intensive businesses and those that require meaningful investment to remain competitive are not good ESOP candidates.

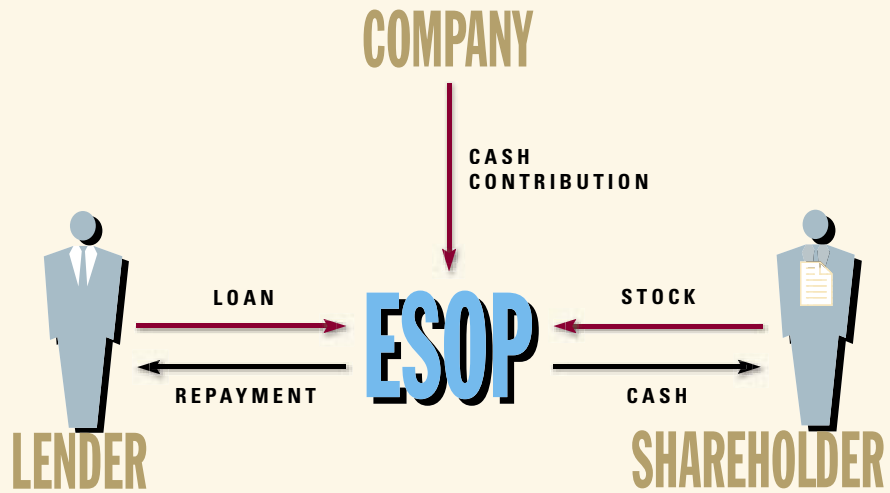
ESOPs must also earmark corporate cash flow to fund participant share redemption obligations. Under "normal" levels of attrition and retirement, this requires that a company "repurchase" itself about every eight to ten years.

WHAT'S IN IT FOR THE EMPLOYEES?

ESOPs can be a boon to employees if the ownership is provided in addition to regular benefits, essentially representing a non-compensated transfer of wealth from the prior owner to the employees. Because all of the

How a Leveraged ESOP Works

In a leveraged ESOP, the ESOP borrows money from a financial institution and uses the loan proceeds to fund the purchase of company stock from shareholders or the company.



retirement benefits are invested in a single private security, ESOPs present a diversification dilemma. Regulations do, however, provide a diversification option for employees nearing retirement.

Clearly, ESOPs are not for everybody. The best candidates for ESOPs are companies where the preponderance of the value is

inherent in the human capital; and therefore, may be difficult to "sell" to a third party and those that do not have heavy capital investment requirements. Even if these particular characteristics fit your circumstances, a seller considering an ESOP should be prepared to remain close to the business for some time after a sale. ♦

Private Capital In the Pacific NW

Venture capital is but one form of private capital, but many are confused as to other sources of private capital.

We recently raised capital to fund the purchase of a local company by its management. This purchase of an established manufacturing company from its UK parent was a traditional leveraged Management Buyout ("MBO") sponsored by its existing management. Funding for the transaction required three types of capital: senior secured debt, subordinated debt, and equity. While we were able to arrange the senior secured debt in the local market, the limited choices for subordinated debt and private equity in the Pacific Northwest required that we seek these riskier forms of capital outside of this region.

While there has been a tremendous amount of venture capital raised in the Pacific Northwest in the past few years, this region has virtually no lenders of subordinated debt and very few private equity investors that are focused on later-stage, "old-economy" businesses.

PRIVATE EQUITY CAPITAL—DEFINED

Private equity capital is available from a

variety of sources ranging from friends and family to sophisticated institutional investors. We find that there is tremendous confusion by those seeking private equity capital regarding whom they should approach.

Venture capital seems to be the term that is commonly used to describe private equity investors. However, while important, venture capital is but one form of private capital.

Different types of investors are attracted to different levels of risk, some want more, and some want less. Accordingly, different types of investors are appropriate at different stages in a company's life cycle.

ANGEL INVESTORS

The earliest stage of funding, so-called "start-up" or "founding" capital is often provided by entrepreneurs themselves. If the business has merit, entrepreneurs quickly seek out wealthy friends and sympathetic family to provide the next increment of capital. These so called "Angel" investors often invest before the business has any meaning-

Credit Market Update

If you can believe the numbers (and we do), the recession of 2001-2002 is drawing to a close. It appears that this economic downturn will be one of the mildest on record. A remarkable testament to the resilience of the U.S. economy given the severe decline in equity values, the massive retrenchment in technology investment, and the unprecedented tragedy of last September.

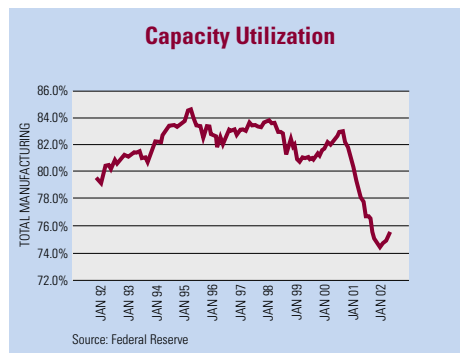
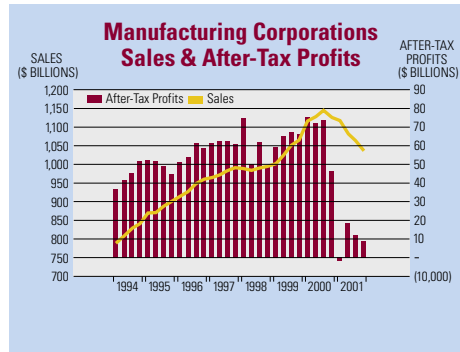
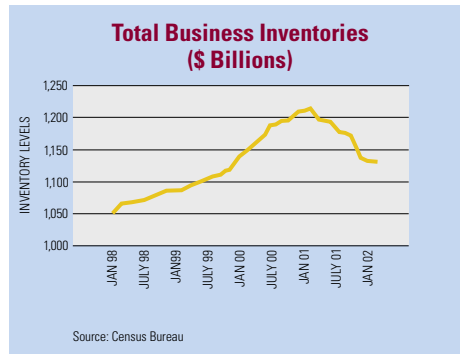
In the past several months, signs have emerged that some of the forces that have been restraining the economy over the past year are starting to diminish and that activity is beginning to firm. Clearly, the benefits of the recovery are not yet being felt in all sectors. Hard hit by the decline in technology and aerospace, the Pacific Northwest continues to lag the national economy. Nationally, however, the speed of the turn-around has been remarkable.

The current downturn—unlike others in the post war period—was not led by a fall in consumer spending. Rather, it began as a sharp reduction in business investment even as consumer spending remained relatively robust. Consumer spending has continued to hold in the face of what would seem to be some pretty dire circumstances. Eleven interest rate cuts by the Fed in a span of less than a year have been a positive contributor.

Lower interest rates have strengthened the value of homes. According to the *Economist*, average U.S. house prices have demonstrated the largest increase ever, rising by 9% in real terms over the past year. And, it is housing where the majority of Middle America's wealth is invested. These higher values, together with the lowest mortgage rates in decades, have encouraged consumers to continue spending (although somewhat at the expense of higher consumer debt). Last year's tax rebate also helped.

While consumers did their best to support the economy, business investment fell off a cliff, precipitating a rapid melt down in corporate earnings. Investment in information and telecommunications technology that was a major driver during the boom has been slashed to the bone in the aftermath. As is typical in an economic contraction, inventory investment took the first hit. The liquidation of inventories was sizable and swift. Near term economic uncertainty, coupled with the higher risk premiums demanded by lenders and more expensive equity capital, caused business managers to severely cut-back on capital spending.

Although this recession will be remembered as mild in terms of its impact to GNP, records will show that it has been one of the harshest in memory when measured by the changes in corporate profits. After-tax



corporate profits declined by nearly 16% last year, one of the worst annual profit declines since World War II. Likewise, capacity utilization recorded the biggest drop in a decade.

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points, the jury is still out. Anecdotal evidence from our clients seems to indicate that business conditions are improving, at least on the sales front. However, taking back the price discounts that were given up during the period of slack demand remains problematic.

So while the economic sector in which we eke out our livelihood remains under pressure, we are sensing a renewed willingness on the part of our clients to take risks. This restoration of confidence, particularly if it can be married with a relaxation of underwriting standards on debt capital will meaningfully accelerate the economic recovery.

Past readers of Insight will recall that we held a more pessimistic view of the economic situation, anticipating a more protracted period of economic softness. In fact, the economy has proven to be more resilient than we had expected. What did we miss? What has changed to provide such resilience and is it reasonable to expect that those factors will continue?

While we do not pretend to know all of the reasons, there are three phenomena that appear to have softened the downturn and accelerated the rebound, including:

1. The access to real-time information by business decision-makers;
2. Increased flexibility in the economy as a result of deregulation; and
3. Innovation in the financial sector.

In today's world, business decision-makers have access to a tremendous amount of real-time information across companies, industries, and countries. Access to identical real-time information allows a more rapid response to changing business conditions. In this manner, imbalances that historically would have taken time to restore can be addressed quickly. Furthermore, information technology has meaningfully contributed to productivity improvements.

In the past decades, many industries have been deregulated, both in the U.S. and internationally. In the United States, air travel, transportation, energy and financial markets are today allowed to respond to market forces. Internationally the list is much longer. Unrestrained, the invisible hand proves to be a powerful motivator.

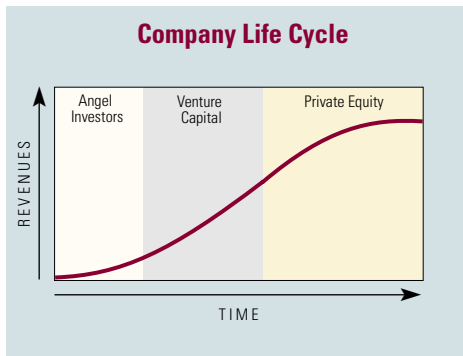
Deregulation in the financial sector has been especially important in enhancing overall economic resilience. New financial products have enabled risk to be dispersed more effectively to those willing and capable of bearing it. As a consequence, shocks to the system are less likely to cascade through the financial markets causing an unrestrained meltdown.

While each period of expansion and contraction is unique, these changes are, we think, here to stay. Although, unlikely to keep us out of a recession, these forces will continue to provide further resilience to the U.S. economy. ❖

Private Equity In the Pacific NW *continued*

ful customers, revenues or clearly articulated business strategy. This is truly the riskiest form of private capital.

Angel investors constitute an entirely unorganized market. By in large, there are no statistics available to measure the overall



size of the market just as there are no standard transaction terms and conditions. Our experience is that Angel investors are generally not adequately compensated for the risk they bear: hence, the term “Angel” which Webster’s defines as “a) a kind and lovable person, b) one who manifests goodness, purity, and selflessness.”

In the Pacific Northwest there have been various attempts to organize Angel investors. These organizations, such as the Alliance for Angels, have generally come together in informal groups. Most recently, organizational efforts seem to have abated, leaving the market for this earliest stage of private equity capital as an unorganized and fragmented market.

VENTURE CAPITAL

Once a young business can demonstrate that customers will pay for a company’s product or service and that the operation is likely to generate a positive cash flow, venture capitalists become interested.

The funding for venture capital is primarily provided from pension funds and insurance companies that place a portion of their investment portfolio into partnerships managed by professional investors. Many new venture capital (“VC”) funds have sprouted in the Pacific Northwest in recent years, raising over \$2.0 billion.

Transaction terms and conditions offered by venture capitalists are more predictable than Angel investors. Although VCs may invest in a minority shares of a private company such investments are typically structured to provide certain priority protections and preferences relative to the founder’s capital.

Venture capitalists invest in companies that are still quite risky. Businesses at this stage of their life cycle remain vulnerable to a variety of shocks that could cause total failure. As a result, venture capital investors seek to earn internal rates of return (“IRR”) in the range of 50%. In order for VCs to achieve such returns, the companies in which they invest must be capable of rapid growth. For these reasons, VCs are not interested in investing in stable, more mature businesses.

PRIVATE EQUITY

The traditional source of outside capital for mature firms has been debt. However, such businesses often have capital needs that cannot be entirely funded by operating cash flow or borrowed money.

Some businesses with these needs can go public, that is, raise equity in organized public markets. However, that opportunity is not available for most companies, either because of their small size, moderate growth prospects, or simply because the owners do not wish to share the inner workings of their business with competitors. These situations are the purview of private equity investors.

There are hundreds of private equity firms in the U.S., managing well over \$100 billion. Most private equity capital originates from institutions that have long investment horizons such as pension funds, insurance

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companies, endowments or public authorities. Wealthy families are also meaningful contributors to private equity funds.

Transaction terms and conditions of private equity investors are reasonably predict-

able. While investments made by these firms are always structured to fit the needs of the particular situation, the return requirements and control issues are much more certain.

Because the businesses that private equity funds invest in are much less risky (already have established customers, assets and cash flows), private equity investors look to earn IRR’s in the range of 25-30%.

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Private equity firms often buy whole companies or will take minority interests if they can, through contractual rights, gain sufficient influence over the board and the exit strategy.

Private equity markets have not developed as thoroughly in the PNW as elsewhere in the U.S. The small share of private equity in the PNW is due both to the relatively small number of private equity investment opportunities as well as the lack of long term investors (insurance companies and pension funds) located here. Interestingly, the wealth created in technology industries in the PNW has not, on the whole, embraced later stage private equity investment opportunities.

Clearly, distinguishing between the various types of private equity investors will greatly reduce the time and effort expended in raising capital. If requirements are for later stage private equity, it makes sense to cast the net beyond the PNW. ♦

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott go to www.zacharyscott.com.

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